L61/2

PRODUCT LIABILITY INSURANCE RATEMAKING

HEARING

BEFORE THE

SUBCOMMITTEE ON GENERAL OVERSIGHT AND MINORITY ENTERPRISE

OF THE

COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

NINETY-SIXTH CONGRESS

SECOND SESSION

WASHINGTON, D.C., OCTOBER 1, 1980

Printed for the use of the Committee on Small Business

NEWARK PUBLIC LIBRARY

DEC 18 1980

U. S. GOVT. PUBS.
DEPOSITORY 376

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON: 1980

68-071 O

Y4.Sm 1:

COMMITTEE ON SMALL BUSINESS

NEAL SMITH, Iowa, *Chairman*

TOM STEED, Oklahoma
JOHN D. DINGELL, Michigan
JAMES C. CORMAN, California
JOSEPH P. ADDABBO, New York
FERNAND J. ST GERMAIN, Rhode Island
PARREN J. MITCHELL, Maryland
HENRY B. GONZALEZ, Texas
JAMES M. HANLEY, New York
JOHN J. LaFALCE, New York
BERKLEY BEDELL, Iowa
FREDERICK W. RICHMOND, New York
ALVIN BALDUS, Wisconsin
RICHARD NOLAN, Minnesota
RICHARD H. ICHORD, Missouri
HENRY J. NOWAK, New York
THOMAS A. LUKEN, Ohio
ANDY IRELAND, Florida
DALE E. KILDEE, Michigan
IKE SKELTON, Missouri
BILLY LEE EVANS, Georgia
DOUG BARNARD, JR., Georgia
CLAUDE LEACH, Louisiana
TONY P. HALL, Ohio
CHARLES W. STENHOLM, Texas
GLADYS NOON SPELLMAN, Maryland
JOSEPH M. McDADE, Pennsylvania
SILVIO O. CONTE, Massachusetts
J. WILLIAM STANTON, Ohio
WILLIAM S. BROOMFIELD, Michigan
TIM LEE CARTER, Kentucky
DAN QUAYLE, Indiana
DAN MARRIOTT, Utah
TOBY ROTH, Wisconsin
LYLE WILLIAMS, Ohio
OLYMPIA J. SNOWE, Maine
DOUGLAS K. BEREUTER, Nebraska
ED BETHUNE, Arkansas
ARLEN ERDAHL, Minnesota
THOMAS J. TAUKE, Iowa
JOHN EDWARD PORTER, Illinois

THOMAS G. POWERS, *General Counsel*
LOIS LIBERTY, *Publications Specialist*
RAYMOND S. WITTIG, *Minority Counsel*

SUBCOMMITTEE ON GENERAL OVERSIGHT AND MINORITY ENTERPRISE

JOHN J. LaFALCE, New York, *Chairman*

JAMES C. CORMAN, California
JOSEPH P. ADDABBO, New York
PARREN J. MITCHELL, Maryland
HENRY B. GONZALEZ, Texas
FREDERICK W. RICHMOND, New York
TIM LEE CARTER, Kentucky
LYLE WILLIAMS, Ohio
DOUGLAS K. BEREUTER, Nebraska

ROBERT I. BRICKMAN, *Subcommittee Counsel*
REID EWING, *Subcommittee Staff Director*
DOUGLAS L. FRANCISCO, *Minority Subcommittee Professional Staff Member*

CONTENTS

	Page
Hearing held on October 1, 1980	1
LaFalce, Hon. John J., chairman, Subcommittee on General Oversight and Minority Enterprise: Opening statement	1
Testimony of:	
Moyer, Homer E., Jr., General Counsel, Department of Commerce	2
Schwartz, Victor E., chairman, Task Force on Product Liability and Accident Compensation, accompanied by George Neidich, senior legal adviser; and Edward T. Barrett, project director	5
Additional material supplied for the hearing record:	
Neidich, George, senior legal adviser: Conclusions and recommendations	35
Schwartz, Victor E., chairman, Task Force and Accident Compensation:	
Appendix A—Background paper	9
Description of staff working draft of the Risk Retention Act	12
Letter to Wayne Granquist, associate director, Management and Regulatory Policy, Office of Management and Budget	8

PRODUCT LIABILITY INSURANCE RATEMAKING

WEDNESDAY, OCTOBER 1, 1980

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GENERAL OVERSIGHT
AND MINORITY ENTERPRISE,
COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:10 a.m., in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN LaFALCE

Mr. LAFALCE. The Subcommittee on General Oversight and Minority Enterprise of the House Small Business Committee will come to order.

This morning, my subcommittee is going to resume its deliberations on the general issue of product liability insurance and its impact on the small business community in particular.

I have worked on this now from 1977 to the present. As we look back, I think we have had at least 15 days of hearings. During that time we have worked extremely close with the administration. We worked with the Ford administration, the Interagency Task Force, and then we worked with the Task Force on Product Liability and Accident Compensation.

One of my problems, perhaps, is that I have worked to closely with the task force. My former subcommittee counsel is the senior legal adviser, and the editor of the Task Force Report on Product Liability and Insurance Rulemaking. I consider this perhaps the best work that I have seen produced from the administration on any subject. I suspect even those individuals who might not agree with the report's conclusions or recommendations would have to join in the tremendous praise that I give it.

The report which took 2 years of data collection and about 6 months to write, explains in great detail the mechanics of ratemaking. I hope that our witnesses will be able to explain the labyrinth in a comprehensible fashion to both the subcommittee and the public.

The task force observes that all of the report's recommendations can be accomplished under the present regime of State regulations. While many of those within the insurance industry may applaud this finding, as it implies no Federal intervention, I also note that the task force conditioned these recommendations with "theoretically it can be"; therefore, I think it is very important that this report be reviewed more as a challenge to the insurance industry than anything else. Additionally, I think those recommendations

should be considered a test whereby the Federal Government can learn whether the insurance industry can reform itself and is willing and able to do so.

To this end, I contemplate holding additional hearings. I contemplate holding hearings immediately after the election, at which time we will have before us those individuals addressed in the recommendations.

Perhaps between November 4 and November 12, when Congress reconvenes, we would like to have the Insurance Services Office, representatives of insurers and State regulators, and, of course, the National Association of Insurance Commissioners, to give their critique, either positive or negative, or a mixture, of this task force report, and also to hear what they intend to do about the recommendations; for example, reject them in total or in part, or accept them in total or in part.

Then perhaps in February of 1981, assuming that I am still a Member of Congress and still chairman of this or some committee with jurisdiction, we would reconvene a hearing to see whether any progress has been made on the representations that I receive in November.

On September 30, the Task Force on Product Liability and Accident Compensation went out of business. I am concerned with the question of what official mechanisms might exist within the administration, and especially within the Department of Commerce, in order to pursue the agenda that the task force has prepared and set out for the public good.

It would be a shame if all the fine work of the task force, including this report, collected dust. I would hope that we could leave it not only to those individuals to whom you made the recommendations, not only to the subcommittee that I might happen to chair, but also to some agency, entity, bureau, department, office, or individuals or committee within the administration, to pursue implementation, so that all these works of the past few years do not come to naught.

With those brief remarks, I would now call upon the General Counsel of the U.S. Department of Commerce, who has provided the continuity throughout, from at least 1976 to the present, and has been the driving force within the administration whenever there have been attempts by others to slow down or impede the work of the task force.

Mr. Moyer, it is a pleasure having you here with us.

TESTIMONY OF HOMER E. MOYER, JR., GENERAL COUNSEL, DEPARTMENT OF COMMERCE

Mr. MOYER. Thank you very much, Mr. Chairman, and thank you for your very kind remarks.

We are indebted to you and to your committee for its assistance and support as the various projects of the task force have proceeded, as well as, of course, for having groomed Mr. Neidich for his present job with the task force.

In my statement, I would like quite briefly, Mr. Chairman, to review the work of the task force in the product liability area, as well as the recent Report on Product Liability Insurance Ratemaking.

As the report represents the final work product by the Department of Commerce in completing the administration's program in the product liability area, it would be appropriate at this time to review our past endeavors. The Interagency Task Force on Product Liability, chaired by the Department of Commerce, conducted an intensive 18-month investigation of the product liability problem.

The study resulted in the publication of a briefing report in January 1977; three contractors' studies examining the legal, insurance, and industry ramifications of the product liability problem; and finally in November 1977, a comprehensive final report. While the final report contained no recommendations for the amelioration of the product liability problem, it did confirm its existence, and identified three major causes which could be addressed:

One, deficiencies in product liability ratemaking procedures;

Two, uncertainties in the tort litigation system;

Three, unsafe manufacturing practices.

In April 1978, the department submitted an options paper to the White House, recommending actions that could be taken to alleviate these identified problems. As a result of that paper, the department was directed to: Prepare legislation extending the carryback period for net operating losses attributable to product liability and related costs from 3 years to 10 years; prepare a model uniform product liability tort law for voluntary adoption by the States; develop a means whereby insurance problems might be eased by facilitating the formation of self-insurance groups; and prepare a report addressing problems in product liability ratemaking procedures.

The Task Force on Product Liability and Accident Compensation has accomplished these goals. The Revenue Act of 1978 amended the Internal Revenue Code to provide for the recommended carryback; a model uniform product liability tort law was published in final form on October 31, 1979, and is presently being considered by approximately 10 States; and the Administration has sent the Product Liability Risk Retention Act to Congress for its consideration, which, as you know, has passed the House and is being considered today in the Senate. Thus, this report, which addresses ratemaking procedures, is the last effort in the product liability arena by the task force.

The report addresses a complex area. It attempts to describe insurance ratemaking practices as objectively and as fairly as possible. It does not call for new Federal involvement in the area of product liability insurance or for major changes in the way product liability rates and premiums are determined.

It does, however, make detailed recommendations that deserve careful consideration by State legislatures, State insurance commissioners, and insurers, themselves. Implementation of these recommendations will be one more step toward preventing future product liability crises.

Mr. Chairman, while we have made copies of the report available to the subcommittee, I would like to take a few moments to briefly summarize its contents.

Mr. LAFALCE. A Herculean task.

Mr. MOYER. I have had Herculean assistance, and I assure you it is only two or three paragraphs.

READEX FICHE

It includes a consideration of the specific data needs of insurance rating bureaus, State regulators, and insurance purchasers. It reviews the various initiatives made by the insurance industry, including the Insurance Services Office's—ISO—amendments to its commercial statistical plan, and the National Association of Insurance Commissioners'—NAIC—Market Assistance Program and Fast Track Monitoring System.

The report includes a detailed exposition and analysis of the various techniques used in product liability ratemaking. This includes an extended consideration of the classification system, manual and judgment rates, and the various rating plans which are used to develop premiums charged to the individual buyer.

The study also considers the decisionmaking process whereby an insurer engages in "the process of hazard recognition and evaluation, risk selection, pricing, and determination of policy terms and conditions." It also explains how the underwriting process provides the opportunity to mitigate inequities built into the product liability ratemaking mechanism.

Further, the report observes that insurers potentially earn substantial amounts of investment income which are not reflected in their rates; as a result, underwriting losses complained of may be significantly offset by these amounts.

Mr. LAFALCE. If I might interrupt you at this point, we are in a competition this morning. You mention that your report observes that insurers potentially earn substantial amounts of investment income which are not reflected in their rates; for a number of years I have been working with a great many individuals concerning this issue, one of whom has been Ralph Nader. This morning, at 10 o'clock, he will be announcing the creation of a National Insurance Consumer Organization. The president of that new group is going to be the former administrator of the Federal Insurance Administration, Mr. Robert Hunter.

The two directors at the present time will be Mr. Howard Clark, former insurance commissioner of South Carolina, and James Hunt, former insurance commissioner of Vermont.

They will be revealing a document that they have been studying for the past few months, called "Taking the Bite Out of Insurance, Volume I, Investment Income in Ratemaking," which, in a certain sense, supplements your report.

They will make the charge that insurance consumers are potentially overcharged $4 billion, and the primary reason is because of investment income.

So when you mentioned that the report observes that insurers potentially earn substantial amounts of investment income which are not reflected in their rates, it is coincidental that another report being released today goes a step further and puts a dollar figure next to it—$4 billion.

I have no way of validating this. I have not read the press release or the document, but I thought it interesting in the same hour we are having the same charge made, in different ways, both by the Department of Commerce and by the newly formed National Insurance Consumer Organization.

Of course, we will be hearing from them, also.

Mr. MOYER. Mr. Chairman, we have not reviewed that report, but on its face it appears to be not inconsistent with our findings.

Finally, the report addresses the various special product liability reporting provisions implemented by the NAIC and 19 States. It observes that most of the State reporting requirements do not provide significantly different data from that required by the NAIC, and ought to be eliminated. However, the report notes that the NAIC reporting requirement is significantly deficient in the manner in which it accounts for investment income.

The report will be sent to the Governors, legislatures, and insurance commissioners of all the States for their consideration and appropriate action.

Mr. Chairman, as this concludes my remarks, I would be pleased to answer any questions you may have.

Mr. LAFALCE. Thank you.

Before I ask questions of you, I know Professor Schwartz has a prepared statement, which I would like to hear. I don't know if Mr. Neidich does.

Mr. NEIDICH. No.

Mr. LAFALCE. Mr. Schwartz?

TESTIMONY OF VICTOR E. SCHWARTZ, CHAIRMAN, TASK FORCE ON PRODUCT LIABILITY AND ACCIDENT COMPENSATION, ACCOMPANIED BY GEORGE NEIDICH, SENIOR LEGAL ADVISOR; AND EDWARD T. BARRETT, PROJECT DIRECTOR

Mr. SCHWARTZ. Mr. Chairman, thank you for your kind invitation to testify here today about the recently released "Report on Product Liability Insurance Ratemaking," as well as an overview of the current product liability situation as it exists today.

As you know, I chaired the Department of Commerce's Product Liability Task Force as well as the Working Group of the Federal Interagency Task Force on Product Liability. My 4 years in Government encompassed both the study and the legislative development phase of the product liability product.

I resigned from my position on August 22, 1980, and currently am a professor of law at the Washington College of Law, American University, and serve in an of-counsel position at the Washington law firm of Crowell & Moring.

I can also assure you that my return to private life has not abated my interest in the product liability problem. In some ways, it has forced me to intensify my thinking about the issue. For example, I am solely responsible for this testimony—I have not had the benefit of having it reviewed by my good colleagues at the Office of Management and Budget in revising, editing and improving of the statement; so if it lacks the luster of prior statements, that is why.

I did want to express my thanks to you, Mr. Chairman, for your interest in developing the facts about the product liability problem. Your 1977 hearings, which went for some 15 days, as well as your followup hearings along each step of our development of legislative proposals, facilitated, encouraged and enlightened us about the nature and scope of the product liability problem. There is no doubt that all of our work products were improved as a result of your steadfast interest and support.

68-971 O—80——2

Perhaps the best place to begin an overview is to focus on two of the principal causes that our task force found to be the root of the product liability problem. First, we noted that uncertainties in the tort system had helped bring it about. These uncertainties continue and have become even more manifest.

Moreover, one can detect new imbalances in the system; some States are bringing tort law to the doorstep of being a compensation system. For example, in Pennsylvania, juries are now instructed that product sellers are "guarantors" of their products. In California, product sellers have both the burden of coming forward with evidence and the burden of persuasion to show why they could not have designed products more safely. In some situations, this burden is almost impossible to fulfill.

Also, in California, in some situations, plaintiffs no longer have to show that a named defendant was the actual manufacturer of the product—it is enough that the product is one that on a generic basis has caused an injury. Although courts in these States continue to say that product sellers are not "insurers" of their products, the underlying rationale of these recent decisions suggests that result.

Obviously, if product sellers are going to be deemed liable whenever their products cause an injury, the need for litigation may disappear. At present, the cost of this litigation is substantial; the Insurance Services Office Closed Claims Survey reflects that cost is approximately 42 cents for every dollar paid in claims. If there are no true issues to litigate, this expenditure serves no purpose. No-fault system alternatives may have to be considered.

The Uniform Product Liability Act—UPLA—has provided some stabilization for the tort system. I have been pleased to see, and surprised to see, that it has been utilized as a source of law by courts. In other words, courts have turned to it as if it were a restatement or leading decision from a sister State. Two legislatures—Connecticut and Idaho—have adopted portions of the act. It is also being considered by about 10 other State legislatures.

Unfortunately, experience to date shows that the States have approached the Uniform Product Liability Act in somewhat of a "shopping bag" fashion. Each State has selected particular positions that are of interest to its legislature. The net result has not been to bring about uniform product liability law in the United States

In spite of this, I would not, at this time, totally give up on a State-by-State approach toward the enactment of a uniform product liability law. After all, the Uniform Product Liability Act has been "in the marketplace" for less than a year.

Nevertheless, a recent bill introduced by Congressmen Richardson Preyer, James Scheuer, Thomas Luken, and Jim Broyhill, of the Subcommittee on Consumer Protection Finance of the House Interstate and Foreign Commerce Committee, deserves very careful attention—H.R. 7921. It is a carefully drafted, pared-down version of the Uniform Product Liability Act. It represents a very limited intrusion into the State tort law system and focuses on the main issues of product liability law.

I am pleased to report that there is a portion of H.R. 7921 that was derived from section 5 of the UPLA, that has received general

approval from a wide range of groups interested in the product liability problem. This section limits the liability of nonmanufacturer product sellers—that is, wholesalers, distributors, retailers—to their own negligent acts.

There are consumer protections included in the section in case the manufacturer is out of business or cannot be reached by judicial process. The section reduces product liability litigation costs without curtailing consumer rights. I am hopeful that it will see more widespread adoption in the near future.

In sum, the developments since you first held hearings on this subject, have not ameliorated the tort law aspect of the problem.

I am more sanguine about the second cause of the product liability problem, overly subjective insurance ratemaking practices. However, my hope would be tempered if the Risk Retention Act of 1980 is not enacted. As you know, an alternative version of that act was very recently reported out by the Senate Committee on Commerce, Science and Technology. See Report No. 96-984, 96th Congress, 2d session, September 23, 1980.

The Senate Commerce Committee's version of the Risk Retention Act impinges less on the powers of State insurance commissioners than the original Commerce proposal. Nevertheless, the Senate Commerce Committee approach accomplishes the basic goals of the Risk Retention Act.

First, it will help assure that rates and premiums are set on a competitive basis; it provides product sellers with an alternative to commercial insurance.

Second, it will help provide additional market capacity should there be a contraction of the market in 1981-82. In that regard, it is important to note that many insurance experts have predicted that such a contraction will occur.

Almost every issue of the National Underwriter or Business Insurance magazines reflects some expert predicting such a contraction within the next 18 months.

The Commerce Task Force's Report also provides some basis for optimism. The report demonstrates that the insurance industry has made great strides in collecting data over the past 2 years. It has also made certain adjustments in its ratemaking practices in order to render them more fair. The task force was most fortunate in the preparation of the technical aspects of the report to have the full and complete cooperation of the ISO and its vice president, Mavis Walters. Ms. Walters has testified before you in prior hearings.

It is important to note that the report demonstrates that the recently enacted State reporting laws are too broad and not helpful vehicles for addressing overly subjective ratemaking practices. These laws are costly to all of us and do not help to resolve the problem.

On the other hand, the report sets forth many specific critiques of ratemaking practices. It calls upon the ISO to implement many of these reforms. It also calls upon the National Association of Insurance Commissioners—NAIC—to help insure the implementation of these and other proposals. While it would be both unrealistic and unfair to expect that ISO and the NAIC would, without review, adopt the recommendations, it would not be in the public interest to have them ignored.

In that regard, it should be noted that the task force declined to call for any new Federal involvement in the insurance industry. The report goes down the path that the insurance industry has generally suggested is an appropriate one for reform—individual State action. This approach is not a synonym for inaction; these recommendations should be given very serious review by the NAIC and ISO. If some recommendations are inappropriate, the respective organizations should indicate why this is true.

Shortly before I left office, I provided Wayne Granquist, the Executive Director for Regulatory Affairs of the Office of Management and Budget, with a summary of the work of our task force. I will provide a copy of that letter for your committee.

[The letter referred to follows:]

U.S. DEPARTMENT OF COMMERCE,
OFFICE OF THE SECRETARY,
Washington, D.C., August 1, 1980.

Mr. WAYNE GRANQUIST,
Associate Director, Management and Regulatory Policy, Office of Management and Budget, Washington, D.C.

DEAR WAYNE: I will be leaving Government service on August 22, 1980, and thought it might be helpful to provide you with a status report about the projects the Administration asked our office to complete regarding product liability and the coordination of insurance functions. As you may recall, Secretary Kreps announced these responsibilities on July 20, 1978. (Description enclosed).

PRODUCT LIABILITY INITIATIVES

Tax proposal.—As a short range measure, the Administration proposed extending the carryback period for net operating losses attributable to product liability and related costs. The general carryback period under the Internal Revenue Code is three years—the Administration proposed extending it to ten. This was enacted into law in October, 1979.

Uniform Product Liability Act. To overcome uncertainties in the product liability tort system, the Administration directed that a model uniform product liability act be prepared. A first draft was published for public comment in the Federal Register on January 12, 1979, and generated over 1500 pages of comment representing 240 communications. Approximately 35 percent of the draft was modified because of that comment and a final version was published on October 31, 1979. (See 44 Fed. Reg. 62714.) To date, portions of the Uniform Act have been enacted in Connecticut and Idaho. It is currently pending before the legislatures of nine states. While we have continued to support the Act as a model for the states, a modified version of the proposal has been introduced in the House (H.R. 7000). Hearings have been held on the measure, but it is not expected to go beyond the Subcommittee stage this session. If the product liability problem continues or grows worse and the states do not take meaningful action on tort law reform, the Administration may, in the future, wish to consider whether a limited Federal standards bill should be supported.

Facilitate self-insurance. To facilities self-insurance on the part of product sellers, Commerce drafted and the Administration approved the Risk Retention Act of 1980. This was proposed as Federal legislation. The Risk Retention Act would allow product sellers to form their own self-insurance groups. Its purpose is to improve competition in the product liability insurance market and assure that rates and premiums were set on a fair and accurate basis. The Risk Retention Act passed the House on March 10, 1980 (337 to 17) and is now before the Senate. On July 30, 1980, Senator Cannon, Chairman of the Commerce Committee, announced his support for a modified version of the proposal. Under the modified version there would be no central Federal chartering office; rather, a group chartered by a state or nation would be subject to only limited regulation by other states. Pursuant to Commerce's suggestion, the Administration has endorsed this modified version of the Risk Retention Act. The proposal has been endorsed by over eighty trade associations including the National Association of Manufacturers and the National Association of Independent Businesses. Consumer groups also support the bill. The insurance industry is now divided with the brokers and some leading insurance companies giving the bill their support. We anticipate that the Risk Retention Act will pass Congress this session.

Insurance ratemaking practices.—To further address problems that have arisen in liability ratemaking procedures, the Administration called for a report that would include draft product liability insurance regulation standards. This report is currently under review at Commerce and will be published this month. Rather than include specific standards, the report will make a number of recommendations to the states and to private industry that should help improve product liability ratemaking procedures. A copy of that report will be forwarded to your office at the time of its publication. It will contain no recommendations for Federal legislation.

Workplace injuries. Product liability problems relating to workplace injuries were addressed in the Uniform Product Liability Act. Also, the Department of Commerce supplies the Department of Labor with an options paper regarding alternative legislative approaches that might be incorporated in any proposed Federal worker compensation bill.

Manufacturing practices. The Uniform Product Liability Act was drafted with one of its fundamental criteria directed at creating incentives for product liability loss prevention. The Task Force also explored whether the Federal Government could do a better job in distributing product liability risk information to manufacturers, distributors, and retailers. After a review of a number of options by agencies that are directly involved in this type of effort, it was concluded that the benefits that might be garnered from any major new initiatives were outweighed by cost considerations.

COORDINATING ACCIDENT COMPENSATION ISSUES

The Administration directed that Commerce form an Interagency Council composed of agencies that have had substantial experience with regard to problems relating to insurance and accident compensation. The Council was formed in January 1979 and undertook an inventory of all current insurance initiatives within the Federal Government. It also assisted OMB in locating appropriate expertise within the Federal Government that could review and comment on both legislative and study initiatives relating to insurance. The functions of the Council are to be transferred to Treasury sometime in the Fall. In reviewing the work of the Council, the Office of Management and Budget decided that it might be appropriate to have a staff located in Treasury that would assist in implementing the Council's functions.

Now that the product liability initiatives have been completed, Commerce will dissolve the Product Liability Task Force (effective September 30). The remaining Product Liability professional and support staff will now work with the Maritime Administration to help it complete a Congressional mandated study on the topic of Oil Pollution Insurance.

In conclusion, it seems an appropriate time to express my very deepest gratitude to you for your guidance, patience and support in our product liability and insurance efforts. Your trust in our Task Force's judgment and abilities has helped make my experience in government a most worthwhile one.

With highest regard, I am,

Sincerely,

VICTOR E. SCHWARTZ,
Chairman, Task Force on Product Liability and Accident Compensation.

[From the Federal Register, Vol. 43, No. 176—Monday, Sept. 11, 1978]

APPENDIX "A"

BACKGROUND PAPER

On July 20, 1978, Secretary of Commerce Juanita M. Kreps announced the first federal program to address the serious economic problems caused by escalating product liability premiums. Speaking for the Administration, she said:

"This is a balanced program which will relieve the product liability problem for American businesses while fully respecting the rights and interests of consumers."

Serious product liability problems have affected thousands of small businesses that have had great difficulty in obtaining affordable product liability insurance. The problem has also affected consumers because insurance costs have been passed on to them in terms of higher prices. Consumer groups have also been concerned about restrictive new state laws that have attacked the problem by limiting the rights of persons to recover damages for injuries caused by defective products. Finally, insurers have expressed concern about court rulings imposing substantial damages in product liability cases.

BASIS FOR PROGRAM

The solution evolved from an 18-month interagency study followed by a Commerce Department Options Paper suggesting remedies. The administration authorized the publication of the Options Paper last April and sought public comment on the Commerce proposals. Commerce received over 400 replies representing close to 10,000 businesses. Consumer and insurer groups also responded to the Commerce Options Paper.

Secretary Kreps indicated that she was pleased to see that "the overwhelming majority of businesses were not looking for a 'federal handout' to resolve the problem." These businesses agreed with the Commerce Department that a federal insurance or reinsurance program was not the solution.

TAX PROPOSAL

As a short-range measure, the Administration proposes extending the carryback period for net operating losses attributable to product liability and related costs. The general carryback period under the Internal Revenue Code is three years—the Administration has proposed extending it to ten. It will also consider an amendment to the Code increasing the number of years to which such a loss can be carried forward. Furthermore, the Department of Commerce and Treasury are reviewing current law on the accumulated earnings tax to the extent that it affects accumulations to provide for product liability losses.

Secretary Kreps observed that the proposal will help ensure that a manufacturer will not be forced out of business because of a product liability judgment. Many such judgments are substantial and unanticipated.

If product liability judgments or settlements give rise to or increase a net operating loss, the proposed amendment will permit the firm to apply the product liability loss against taxable income earned during the ten preceding years. It will provide for an immediate refund of taxes paid during those years and will tend to ensure that taxpayers will be in a position to realize promptly the tax benefits of deducting the loss. This will also help ensure that a person injured by a defective product will be able to collect a product liability award.

Under the proposal, a business having problems with insurance affordability may be able to buy insurance with a larger deductible. It could rely on cash it has on hand plus the tax refund from carrying the loss back to prior taxable years to cover retained risks. Treasury had developed this proposal in response to the serious and unique interstate economic impacts of the product liability problem, including the fact that product liability exposure extends to a wide spectrum of taxpayers and may result in unanticipated losses of significant magnitude. The proposed amendment would be limited to product liability.

Because of cost factors and concerns about a questionable precedent, the Administration has endorsed the loss carryback proposal rather than a proposal which would have permitted businesses current tax deductions for contributions to product liability self-insurance trusts. The Administration believes that the carryback is simpler, both for affected taxpayers and the Internal Revenue Service. It will provide the same benefits, other than deferral of taxes, as a current tax deduction for contributions to a self-insurance trust.

While the Department of Commerce had supported the deferral approach, Secretary Kreps stated that the carryback alternative "may result in a better use of business capital, since funds would not be required to be maintained in a segregated low-yield fund."

ATTACKING THE CAUSES OF THE PROBLEM

Secretary Kreps also stated that, "The Administration has sought to attack the basic causes of the product liability problem, rather than camouflage them with various short-range solutions." The Commerce Department, as the result of its interagency study, found that the causes of the problem were: uncertainties in the tort system, problems with insurance ratemaking practices, and the manufacture of unsafe products. The Administration will pursue Commerce recommendations aimed at each of these causes.

UNIFORM PRODUCT LIABILITY LAW

To attack uncertainties in the tort system, the Administration has directed that a model uniform product liability law be prepared. Secretary Kreps said:

"While this is a major effort, it will be completed promptly. We will seek advice from the states as well as the different interest groups affected by the product liability problem. We want to draft a balanced code that will add needed stability to product liability law."

WORKPLACE INJURIES

"A serious problem within the tort system is product liability suits that arise out of workplace accidents." When an accident involving a manufactured product occurs in the workplace, the worker is usually eligible to collect Worker Compensation. The worker may also bring a claim against the product manufacturer. The net result may be that the product manufacturer pays the entire cost of the worker's award, even though the employer's negligence was a substantial cause of the injury. The overlap of tort and Worker Compensation systems has been costly. A recent survey showed that while workplace accidents represent only 11 percent of product liability claims, they result in 42 percent of the amount insurers pay in settlements and judgments. The duplicative transaction and legal costs result in a good deal of waste. Secretary Kreps observed:

"Overall Worker Compensation proposals now being considered by the Labor Department provide an ideal climate for addressing the workplace product liability problem. The Department of Commerce will propose a provision affording relief for product manufacturers as a part of any Administration Worker Compensation legislation. The provision would insure, however, that the manufacturer of a deficient product makes an appropriate contribution to pay for the worker's claim."

The provision would be part of any Worker Compensation reform effort that would include adequate benefits and expanded coverage for workers suffering product-related injuries in the course of employment.

INSURANCE RATEMAKING

To address problems in liability ratemaking procedures, the Administration has called for a report that would include draft product liability insurance regulation standards. The report would, among other things, evaluate:

"The appropriate federal role in product liability insurance.

"The effectiveness of initiatives by state regulators and the insurance industry to address the problem.

"Whether product liability premiums can more closely reflect actual product risk, e.g., extending experience rating to small business.

"Whether insurance problems may be eased by facilitating the formation of self insurance groups."

MANUFACTURING PRACTICES

To help ensure the manufacture of safe products, the model uniform product liability law will preserve existing incentives in the tort-litigation system. The Administration has also called for a cooperative effort "whereby the Federal Government would more effectively distribute product risk information to manufacturers, distributors, and retailers. At the same time, the Administration urges industry to voluntarily disclose information regarding product risks of which they become aware to product manufacturers and concerned government agencies." Commerce would work closely with the Consumer Product Safety Commission, the Department of Labor, HEW, and other appropriate agencies in promoting such efforts.

COORDINATE ACCIDENT COMPENSATION ISSUES

Finally, the Administration approved Commerce's proposal to improve the coordination of federal accident compensation initiatives. Secretary Kreps observed:

"Problems relating to accident compensation are unlikely to fade away in the next few years—in point of fact, all signs suggest they will grow worse. There already is a multiplicity of federal legislative and research initiatives being undertaken in the area of accident compensation.

"Therefore, the Administration will form an Interagency Council composed of agencies that have had substantial experience with respect to problems relating to accident compensation. Some of these agencies include DOL, DOT, HEW, and the Federal Insurance Administration of HUD. Also included on the Council will be the Office of Management and Budget, the Council of Economic Advisors, and the Office of the Special Assistant to the President for Consumer Affairs. The Council would:

(1) Inventory present programs and initiatives;

(2) Serve as a clearinghouse for research on accident compensation and insurance issues;

(3) Serve as a forum for discussing legislative initiatives in the accident compensation-insurance area, and

(4) Serve to identify expertise on this subject matter within the Federal Government."

The Department of Commerce will convene the Council and direct the product liability initiatives.

[FR Doc. 78-25616 Filed 9-8-78; 8:45 am]

DESCRIPTION OF STAFF WORKING DRAFT OF THE RISK RETENTION ACT

On April 22, 1980, the Commerce Committee held a hearing on the Administration supported Product Liability Risk Retention Act, H.R. 6152. Based on a review of the hearing record and a subsequent meeting at the Department of Commerce concerning the operation of association captives, the Committee staff has prepared a draft bill, "Staff Working Draft", which would preempt certain laws which affect the operation of association captives, but which would not impose any new Federal regulatory authority. The reasoning behind this approach is that it appears that groups can "create" captives under the laws of certain states, such as Colorado, or "create" an offshore captive. But, certain laws or regulations may hinder the "operation" of captives, if they seek to conduct operations outside the state in which they are organized.

Since the states and foreign governments have in place insurance commissioners who are in the business of issuing charters to insurance companies, it appears unnecessary to create any new Federal regulatory bureaucracy. The definition of a risk retention group provides that the group must obtain a charter from a state or foreign national authorizing it to act as an insurance company. It is intended that the risk retention group would comply with all of the legal requirements imposed by the jurisdiction in which it is chartered. It would not however, be required to meet multiple or conflicting regulatory requirements imposed by other states (except that it would be required to comply with claims settlement laws, pay state taxes, and participate on a non-discriminatory basis in any guarantee fund, if required by state law to do so).

Section 4 of the Staff Working Draft preempts state laws which hinder the formation and operation of group marketing arrangements for product liability insurance. Although different in form it is substantially similar to Title II of H.R. 6152. Section 4 clarifies the fact that a "purchasing group" may provide coverage for product liability, completed operations, and comprehensive commercial liability insurance (which is consistent with the way such insurance is currently marketed).

Section 5 of the bill adopts provisions of H.R. 6152 which exempt a risk retention group from the requirements of Federal security laws. It also adds a provision exempting a risk retention group from state blue sky laws. Since interest in a risk retention group will not be sold to the public, making it comply with the security laws is unnecessary.

Mr. SCHWARTZ. It shows that with the publication of the insurance report, the task force completed each and every assignment that the administration assigned to it and did so within a 2-year framework. On occasion, it is worthwhile for Government task forces to do their job and then shut down. The Product Liability Task Force accomplished this yesterday, September 30, 1980.

Mr. Chairman, you helped bring the work to its fruition, and I thank you. If I may be permitted a personal note, Edward T. Barrett has worked for me for 4 years, and I can assure this committee and everyone in this room that none of this would be possible without his help, his guidance, his instruction to me in the ways of Government, and also his thought in approving and developing these work products.

Mr. LAFALCE. I want to thank both of you for your testimony.

What I would like to do now is ask a few questions so that I might better understand what has gone on and what you have actually reported. I will ask the questions generally and any of the three of you might respond unless I should address a question to one of you in particular.

Mr. Moyer, on page 2 of your testimony, you state that the Department submitted an options paper to the White House recommending actions that could be taken, and you then state that the administration directed the Department to follow four courses of action.

Before I go into those four courses of action, I would like to find out what options you recommended that may have gone beyond the directives of the administration and that might well have been preferable.

For example, I understand that directive No. 1, to prepare legislation extending the carryback period for those operating losses attributable to product liability and related costs, 3 years to 10 years, would not benefit a good many small businesses. It is certainly not what they desired. I also understand that this was not the option preferred by the Department of Commerce or by the task force.

What was the option on that issue that was preferred by the Department of Commerce?

Mr. MOYER. Professor Schwartz can elaborate. My recollection on that one, in particular—and I don't recall the details of our initial recommendation—is that it triggered quite an intensive process of discussions among Commerce, Treasury and other agencies in the Government interested in that.

There was a set-aside proposal. It was one of the original options. The options paper, as I recall in that particular, really served to put a proposal on the table and propel the process of considering what made most sense within the context of the tax structure given the separate interests of the Treasury Department.

Mr. LAFALCE. Was it not the first preference of the Department of Commerce to call for the creation of self-insurance trust funds into this, so individual companies could establish reserves which would be deductible under the Tax Code as opposed to nondeductible under the present code?

Mr. MOYER. Our first proposal was indeed along those lines.

Mr. LAFALCE. That was rejected by the administration, and their substitute, as I understand it, was basically the extension of the loss carryback period, accompanied perhaps with the concept of risk retention.

Mr. MOYER. I would quite frankly characterize it a little bit differently.

Mr. LAFALCE. Surely.

Mr. MOYER. That process was much more collegial than confrontational, as your comments might connote. On that issue in particular, it was a very technical and extended set of discussions.

Mr. SCHWARTZ. The discussions did lead to the development, as you suggested, of the Risk Retention Act. Treasury's basic concern about the original Commerce proposal, and that concern was adopted by the administration, was that if you did not have a distribution of risk, then you do not have insurance as insurance is characterized under the Internal Revenue Code, the Commerce proposal which allowed one company to set-aside funds—$25,000 or $100,000 in the proposal, $25,000 for all businesses, $100,000 for business with a serious product liability problem—you didn't have a distribution of risk: Therefore, it wasn't insurance.

Commerce presented its views forcefully in interagency councils, but the tack that was taken was against the set-aside, with the charge being to develop the Risk Retention Act.

Mr. LAFALCE. The carryback?

Mr. SCHWARTZ. Excuse me. The carryback. Then to develop the Risk Retention Act. That act, as developed by Commerce, was——

Mr. LAFALCE. We will get into that separately, but I want to stick with the issue of the carryback as opposed to the self-insurance trust fund.

Mr. Neidich, you had extensive meetings with the Department of Treasury regarding this issue. It is my recollection that you wound up, perhaps, agreeing with Treasury, and I wondered, first of all, if you can confirm my recollection, and if that is correct, would you explain why?

Mr. NEIDICH. My recollection is that at the time Treasury's concern was what they categorized as an "unfair subsidy" inherent in the proposals. As a result of the meetings I had in my other life with Treasury, I became satisfied there was, in fact, a subsidy; however, it was a political question as to whether that subsidy was unfair or unwarranted. But there was, in fact, a subsidy inherent in the proposal.

Mr. LAFALCE. Is there a subsidy involved when there is a loss carryback, an extended one?

Mr. NEIDICH. Not necessarily. A subsidy would result only in the event that a firm, after realizing significant product liability losses, which were carried back to the fourth through tenth years, went out of business; in such event, the firm would not be in existence long enough to benefit from a loss carryforward. However, if the firm were able to continue in business, there would just be a shifting because the loss of tax benefit and no subsidy would not be wasted; the loss would be carried forward for 7 years. The proposals' only effect is to enable a business to recoup taxes paid going back 10 years instead of 3 years, immediately.

Mr. LAFALCE. Mr. Moyer, I strongly supported the Risk Retention Act. As a matter of fact, I think I was the first Congressman that introduced the Risk Retention Act as developed by the Department of Commerce. The Senate then insisted upon certain changes. Not only did I go along with those changes, but, in fact, those changes may well have improved the Risk Retention Act; they certainly made it more politically palatable.

Because of that, I was hopeful of immediate passage in the Senate, but instead, we have seen procrastination and delay, and I am not sure that the administration has done very much to overcome that procrastination and delay. We have today and tomorrow before the lameduck session—at least in the House.

In your prepared testimony you indicated that the bill was presently pending in the Senate. In your verbal presentation you said the Senate intended to take it up today. Could you expatiate on that?

Mr. MOYER. The path of the bill, as you know, has been a complicated one. It has been joined with other legislative proposals, specifically proposals dealing with tourism and has been reported out in that form. My understanding, as of this morning, is that the tourism part of the tandem has been modified, and there is a compromise tourism proposal. They are to be considered today on the Senate floor, and I think that is the result of what has indeed been considerable perseverance in attempting to see that through.

Mr. LAFALCE. What you are saying is that basically Senator Cannon has insisted on some tourism bill and has used the Risk Retention Act as a vehicle to attach the tourism bill to. The tourism bill was basically unacceptable to the administration in the past. I think that is what you have said. Have you also said that the administration now favors the tourism compromise that has been reached with Senator Cannon?

Mr. MOYER. The compromise tourism proposal contains considerably fewer of the most objectionable provisions that originally were in it. As to what the administration's position would be on that tourism bill, if, in fact, they emerge from conference still tied, I can't say as of this moment. I am encouraged by what has happened in the last 24 hours.

Mr. LAFALCE. Time is our common enemy. I am a bit sluggish this morning because we were in session until 2:30 a.m. last night, and I expect we will be in session late tonight.

Have you been meeting with potential House conferees on this issue?

Mr. MOYER. I have not personally. Our Congressional Affairs Office has been very active on this issue.

Mr. LAFALCE. I think your Congressional Affairs Office should contact me and give me a rundown on what is happening, and what they are doing, to see if I can't be of some assistance.

Mr. MOYER. We shall do that.

Mr. LAFALCE. Professor Schwartz, first of all, I thought your testimony today was excellent. But there are some things in today's version that make me wonder about some of your statements in the past. I think it would serve some value for us to discuss what I am reading between the lines.

On the one hand, you have prepared a model uniform product liability tort law for voluntary adoption by the States. On the other hand, I see great concern in your remarks at the approach that is being taken in some States. You have difficulty with Pennsylvania law that you say makes product sellers guarantors of their products; you have difficulty with California law, it seems to me, which shifts the burden of coming forward and the burden of persuasion. You indirectly make reference, I think, to the DES cases in California, where you say that you no longer have to prove that the product was sold by a particular manufacturer. It is enough to suggest that the product is one that on a generic basis causes injury.

You also speak of the number of cents per dollars paid in claims and wonder if there are issues to litigate other than the issue of the injury, of course.

It seems to me that you are heading in the direction of no fault for product liability cases or at least for a certain class of product liability cases. It also seems to me that that is in fundamental opposition to the model uniform product liability tort law that you have espoused for State adoption. Can you help me in this?

Mr. SCHWARTZ. Consistency is the hobgoblin of little minds, but I will make a stab at it.

In our original options paper, I think recommendation No. 7 suggested that further study and consideration be given to no-fault options in the area of product liability. That option was neither

approved nor disapproved by the administration, but there were no funds to develop it at that particular time.

In the past, with no no-fault and product liability, professors and others have fallen into two camps: Some who say you should have a no-fault system, and some who say it wouldn't work.

It is my judgment that in the next 5 years in certain limited areas, no-fault may be appropriate for certain types of products in certain specific situations if the liability system for those types of products is tantamount to absolute liability and makes a product seller an insurer.

For example, if California were to treat manufacturers of pharmaceuticals as responsible for all harms caused by those pharmaceuticals—it is not currently the law, but if the Supreme Court of California took that step, and it could—then a pharmaceutical manufacturer may choose——

Mr. LAFALCE. Just how have they gone in the DES case?

Mr. SCHWARTZ. With generic products you do not have to prove causation. The pharmaceutical——

Mr. LAFALCE. Is that a correct statement, or you have to prove causation but use some statistical assumptions?

Mr. SCHWARTZ. You have to prove that the product caused your injury, but you don't have to prove which manufacturer made the product. That is in doubt.

The pharmaceutical manufacturer still has one important defense in California. If it is a pharmaceutical that is unavoidably dangerous, it produces a risk that cannot be avoided under current technology, assuming the manufacturer warns about that risk; the manufacturer is not subject to liability. But that doctrine which in the restatement is 402-K could change in California. California, unlike other States, has said it doesn't follow the restatement; it goes its own way, and everytime it has gone its own way, it has been toward expanding liability.

Assuming they take the next step, and they could, a manufacturer might consider whether it wants to pay persons who are injured by a product, damages that they do not otherwise receive through their own Blue Cross or other insurance. It is something that manufacturers will probably give some consideration to.

But this is not at odds with the Uniform Product Liability Act. I do not intend to suggest any type of wholesale product no-fault system in product liability. In fact, I think such a system would be counterproductive because one of the benefits we have had from product liability law is it has created an incentive to make safe products.

Mr. LAFALCE. I just don't want to lose sight of the fact. In your initial interagency report you spoke of three causes which should be addressed: deficiencies in product liability ratemaking procedures; uncertainties in the tort litigation system; and unsafe manufacturing practices.

I am not really sure what we have done so far as unsafe manufacturing practices. I hope Mr. Moyer will come back to that later. Please continue.

Mr. SCHWARTZ. To answer your question, I do not see them at odds with each other. It is just that there may be certain islands where no-fault systems may be appropriate. That is all.

Mr. LAFALCE. I think it would be helpful if we could have a better understanding of the contour of those islands.

Mr. SCHWARTZ. It would be with products that tend to injure only the user, not a bystander, of a product. The pharmaceutical might be a good example. It would be with products where the liability situation today is very close to absolute, and it would be if product liability law in more States follow what Pennsylvania and California have done to date.

There is a very confusing thing in product liability law. It confuses everybody. About 45 States say they are applying strict liability but only a few really apply strict liability in design or duty to warn cases. They are essentially applying false negligence standards. As they apply strict liability in those areas, you are forced to almost an absolute liability system after an accident. You can always figure out a new warning. It is sort of like playing football on Monday. After you have spent x number of dollars, you could have designed the product more safely.

Mr. LAFALCE. Professor Schwartz, in your prior life——

Mr. SCHWARTZ. We may not be making any law here, but the entertainment is good.

Mr. LAFALCE. Going back to that prior life, I recall you saying that this uniform model product liability law could be adopted by the States, and that this was preferable to adoption by the Federal legislative body.

In your new reincarnation, or if not that, certainly with the new wisdom and knowledge that you gained from the passage of time and the experience of State legislative action, would that still be your opinion? Or would you have come to hold new views?

Mr. SCHWARTZ. It becomes more of a hope as time goes on. I have testified in about 10 State legislatures. I have had that experience since we last met in this hearing room. The tendency I see in these legislatures is due to exactly what you said they would do, that is, go through the Uniform Product Liability Act and pick and choose provisions that they may like.

The net result in a particular State may be brought about by the balance of lobbying interests. For example, in a State like Utah, where consumer interests were not particularly strong before the State legislature, a very short statute of repose was adopted. That experience occurs in other States. I would rather not get into naming which States are one way or the other. But that does not lead to uniformity.

The second development that has made me more on the fence on this particular question is H.R. 7921, which is sort of a grandson of the Uniform Product Liability Act, or grandchild. It shows that you can have a very limited invasion with no procedural aspects, very much, if you would, like a precedent toward the act of 1909, which set forth a substantive rule for accidents in interstate commerce for railroads, but did not provide rules as to how that was to be implemented. That law has been interpreted by State courts for 71 years. The Scheuer-Preyer-Broyhill bill does just that. For that reason I think hearings on that bill would be very appropriate to hold.

Mr. LAFALCE. Would you spell out the provisions of H.R. 7921 in basic form?

Mr. SCHWARTZ. The provisions include your basic standards of responsibility: When a manufacturer is liable for construction defects, when the manufacturer is liable for design defects, when the manufacturer or product seller is liable for failure to warn. The bill indicates the effect of the state-of-the-art or state-of-technology compliance, and how that fits into product liability law when the manufacturer has done the best it could do in terms of practical technological feasibility.

The bill indicates what compliance with a Federal or State safety regulation has in product liability. The bill indicates that product sellers, who are not the manufacturers, should only be subject to liability for their negligence unless the manufacturer is out of business or cannot be reached by process.

Mr. LAFALCE. That is extremely important. That is the section of the UPLA; is it not?

Mr. SCHWARTZ. Yes, it is.

Mr. LAFALCE. I am wondering if that section 3 cannot almost stand on its own, and you might be able to accomplish a great deal of good, particularly for the small business community, if that provision were adopted by every State or adopted federally.

Mr. SCHWARTZ. I singled out that provision because it has had a special nature about it. It does not, as a practical matter, reduce the rights of people who are bringing claims, which statutes of repose could.

On the other hand, it cuts costs.

Mr. LAFALCE. It cuts the middleman out.

Mr. SCHWARTZ. That is right, and you will find in the commentary you had made a suggestion with respect to that section at the last hearings, saying, "what about the difficulty of the plaintiff obtaining evidence?" You will see that in our commentary we say the claimant would have the right to depose or treat the nonmanufacturer product seller as a party, if it was necessary to do that to obtain the evidence.

It can stand by itself.

Mr. LAFALCE. Very good.

Mr. SCHWARTZ. There are provisions on statutes of repose, also a provision that relates worker compensation and product liability law.

Mr. LAFALCE. What does it not contain?

Mr. SCHWARTZ. It does not contain any provisions on arbitration, notice of claim, or any procedural portions that were in the Uniform Product Liability Act.

Mr. LAFALCE. Such as?

Mr. SCHWARTZ. Arbitration was one; requiring a notice of claim was another. There are some other detailed ones I can supply to the committee. It also does not contain any provisions that would be deemed broad-scale tort law provisions such as damages for pain and suffering. That is not in there. The collateral source is not in there.

Another procedural matter that has been eliminated is the rule that would eliminate evidence of both manufacture repair or improvement of product. That was deemed a procedural vehicle, and it was eliminated by the committee. It has a more limited comparative evidence treatment than the Uniform Product Liability Act.

There was first H.R. 8700, which cut down UPLA quite a bit, and then this bill. It is as if a surgeon worked to get at the very heart of provisions that dealt with common issues that arise in product liability cases. That is the net result.

As far as the worker compensation provision, that is the provision where we followed what you had done rather than the approach we had taken, and I must say in terms of the public reaction to it, it is much more favorable than the approach that we had originally taken.

Mr. LAFALCE. I think in every instance where you followed the recommendations, you certainly improved the product. Let's go to the labyrinth. I have to go a bit slowly on this, because I had difficulty understanding some portions of it. I would like to walk through it.

Mr. Neidich, as editor, I hope that you can help me in that walkthrough somewhat. Of course, I think Mr. Moyer or Professor Schwartz, to the extent you would like, please feel free to give your comments, also.

I am not sure of the best approach to take in trying to understand more fully than I presently understand the import of this report, but I think it might be best to go to pages 1 through 5 of the report and to look at the conclusions and recommendations that you have made and perhaps by discussing your conclusions or recommendations, which you have codified into five pages, and expanding upon them, we might come up with a better understanding of the report.

Mr. Neidich, let's take them one by one. First, you make certain conclusions and recommendations with respect to ISO, with respect to insurers, State regulators, et cetera. Let's take ISO. You make 24 conclusions or recommendations. I don't know that we should go through all 24 of them, but why don't you read them yourself. Which do you think are especially important and worthy of comment? Let's take them in order. Certainly it would seem to me that item No. 1 demands some explanation.

Mr. NEIDICH. Amend its present classification scheme to one which uses the standard industrial code methodology to five digits.

That is discussed at pages 32 through 37 of the report.

ISO presently uses something of a corruption of the SIC methodology for its classification system. They have a scheme of 417 classifications which are based on a five-digit code. The first three digits of the method that ISO uses presently correspond to the SIC code methodology. The latter two digits are not at all the same.

For example one of the principal disadvantages of the present ISO system is if they are collecting data at one level of detail, for example, all pipes, and it subsequently becomes necessary to assign a separate rate because the experience warrants to lead pipes, it is impossible to segregate that experience out of that larger experience.

One of the unique characteristics of the SIC code methodology is that if you collect data at a given level of detail, it is possible to build back up. For example, if they are collecting detail at five digits, they can go ahead and aggregate all those to four digits.

Mr. LAFALCE. Let me pursue that a bit. You said if you are collecting data in adequate enough detail. As you recall, when

representatives from the industry were testifying in 1977, they admitted their embarrassment at the paucity of data that existed. It is my understanding that because of that paucity and because of their embarrassment, they did attempt to collect additional data.

Do you think that the data that is now being collected either by the insurance companies or by ISO is: One, adequate enough in general to give us the data we need to make whatever conclusions we should reach in general, and two, adequate enough to go to the standard industrial code classification methodology, the five-digit approach, rather than the present three-digit approach?

Mr. NEIDICH. In answer to your first question, I think the answer is yes, that I think ISO generally is collecting appropriate data.

In answer to your second question, the answer is no, that ISO would have to change its classification system to one that would coincide with, or be more akin to, the SIC code methodology.

Mr. LAFALCE. I understand they would have to change the classification system. My question is, do they now have the data so that if they change their classification system, they could use it?

Mr. NEIDICH. Not entirely. While they would be able to do that, there would definitely be a transition period.

Mr. LAFALCE. To that extent at least, there would still exist—I hesitate to use the word paucity of data—but still insufficient data to permit them to go to the standard industrial code classification?

Mr. NEIDICH. It is not so much a paucity of data; it is just the data is not being collected in a fashion that would enable them to do so.

On pages 36 through 37, there is an exhibit of all the different classifications presently being collected under ICC-59993. There is a chart that continues on to page 37. It shows approximately 1 dozen different types of product sellers with different rates being assigned to each. However, ISO is not collecting data in a fashion that allows them to make these necessary distinctions. These distinctions are being made by underwriters absent any other data. There is aggregate data but not detailed data they can isolate to enable them to do this.

Mr. LAFALCE. What decisions did you say are being made by underwriters?

Mr. NEIDICH. The (a)-rates—but, I will get to that generally in a moment.

Mr. LAFALCE. Let's stick with No. 1.

Mr. NEIDICH. Their classification methodology does not enable them to distinguish among these different types of product sellers.

Mr. LAFALCE. You say they are getting adequate enough data, but not in the form in detail that would enable them to shift or make the transition immediately to the SIC methodology.

Would it be that difficult, in your judgment, to have this data that comes in, have the nuances rather than lead pipe or what have you that would permit them to make this transition?

Mr. NEIDICH. I don't believe that would be difficult at all.

Mr. LAFALCE. Have you discussed that?

Mr. NEIDICH. No. We have not, in part, because we wanted to get this report out as soon as possible.

Mr. LAFALCE. Which recommendation of the 24 for ISO should we take next?

Mr. NEIDICH. I would go to No. 2 next, which "determine its (a)-rates actuarially which in the aggregate reflects the projected loss experience of all (a)-rated classifications."

Mr. LAFALCE. I thought one of the ways of defining (a)-rate was to say it as not actuarially determined, and if by definition something is not actuarially determined, how can we require it to be determined actuarially?

Mr. NEIDICH. An (a)-rate—a judgment rate—is generally a rate which is assigned to a classification which is nonhomogeneous, which embraces very many different types of risks, so that a single rate is not necessarily appropriate to any of those rates.

The (a)-rate that ISO used purports to be the average rate for the average risk. This is a guide rate—the starting point for an underwriter. That being the case, it would appear that it should be a mathematically determined rate which is neither excessive, inadequate, or otherwise inappropriate, rather than a rate that has been arrived at by judgment.

Mr. LAFALCE. Rather than by judgment exclusively.

Mr. NEIDICH. Exactly.

Mr. LAFALCE. We have never said that (a)-rates are exclusively judgment rates. We have always said they are in large part judgment-rated.

Mr. NEIDICH. No. An (a)-rate is a judgment rate, and this is not intended to change that. In other words, for a particular risk an underwriter would remain free to exercise his underwriting judgment as to what the appropriate rate for a particular risk should be, but he would have, in making that determination as a starting point, a rate which is mathematically determined to be an average rate for the average risk.

Mr. LAFALCE. That is why I have said in the past that (a)-rates are in large part subjectively based.

Mr. NEIDICH. Right.

Mr. LAFALCE. That means in part they have not been subjectively based.

Mr. NEIDICH. I don't think you have quite said that (a)-rates are——

Mr. LAFALCE. I have said that.

Mr. NEIDICH. If you said that, I think that is wrong. I believe (a)-rates are subjectively based, period.

Mr. LAFALCE. Totally?

Mr. NEIDICH. That there is no actuarially analysis made to them.

Mr. LAFALCE. I have been too kind with the industry then. Is there presently no mathematical bases?

Mr. NEIDICH. Initially ISO was unable to determine (a)-rates actuarialiy because they were not collecting appropriate information. ISO has amended its commercial statistical plan so it is now receiving information which enables them to do this. However, to date, they have not made such an analysis.

Mr. LAFALCE. So what we are saying is that ISO can do a lot better than they have thus far in coming up with some actuarial basis for a certain classification of rates. Whether they would want to call them (a)-rates or not would be up to them.

Mr. NEIDICH. Yes.

68-971 O—88——4

Mr. LAFALCE. There is a whole body of rates that are being formed that could have a greater actuarial basis and greater objectivity. They can call them what they want, but it would help lead to much more objective premiums being charged.

Mr. NEIDICH. The company should remain free to apply its underwriting judgment to those classifications, again assuming that they are heterogeneous. At least, as the starting point, the initial suggestion the company will be receiving is something that is mathematically sound.

Mr. LAFALCE. Any rate is always subject to a subsequent underwriting judgment. We are just talking about the initial rate now.

Mr. NEIDICH. Exactly.

Mr. LAFALCE. I am hesitant to ask this. When I first embarked upon the hearings, I recall ISO testifying that of the total product liability premiums approximately 10 percent was based upon manual rates and approximately 90 percent was in large part based upon the subjective judgment of the individual insurance underwriter.

I think approximately a year ago they said that the ratio had changed to 20/80. I could be mistaken. I will stand corrected. Do you know what their estimate would be today in the total universe of product liability dollars?

Mr. NEIDICH. No, but I would be able to make certain inferences, if I might.

Initially, the breakdown was something like less than 10 percent were manual, approximately 30 percent were (a)-rated, approximately 30 percent were package policy rates, and the remaining 30 percent were large (a)-rated, loss rated, or composite-rated.

At that time, the only detailed information available was with respect to the manual monoline, which was less than 10 percent. Now 150 is capturing detailed information for (a)-rates, which was 30 percent, they have done away with including product liability rating within package policies, so that knocks out another 30 percent. Then they have prohibited composite rating with the exception of large (a)-rating and loss rating. Thus, something less than 30 percent is presently escaping the 150 reporting mechanism, assuming that the relative proportions remain unchanged.

Mr. LAFALCE. So it would seem. When did they start doing that?

Mr. NEIDICH. I believe some of those changes started in 1974-75.

Mr. LAFALCE. When do they become operational?

Mr. NEIDICH. The changes were not all made at the same time. They were phased in over a period of time.

Mr. LAFALCE. Good. Shall we discuss item No. 3—"determine (a)-rates without regard to expense and profit loading."

Mr. NEIDICH. While we can discuss that now, I would rather discuss that in the context of manual rates.

Mr. LAFALCE. Shall we discuss No. 4 now?

Mr. NEIDICH. Yes. No extended discussion is warranted.

Mr. LAFALCE. Provide for each classification a range of (a)-rates which represent the average rate for the average risk.

Mr. NEIDICH. The principal point is that now ISO provides a single rate, for example, $1 per $1,000 of sales, which purports to be the average rate for the average risk. However, the underwriter who is using these guide rates has no notice of how broad an

average this is. Is the average really $1 to $3? Fifty cents to $3? By providing a range, it would put the underwriter on better notice as to what the average is, and he would be able to use them in a more effective fashion.

Incidentally, at one point ISO did use a range, and they have stopped doing that.

Mr. LAFALCE. Did they indicate why?

Mr. NEIDICH. I don't know.

Mr. LAFALCE. No. 5, I certainly think we should treat. You recommend that ISO requires that present ICC-37101—manufacturers of autos, trucks, and buses—not be included in the actuarial determination of (a)-rates, and should be treated separately.

It is my understanding that particular code number accounts for a tremendous number of product liability cases. Is that correct?

Mr. NEIDICH. Of losses, yes. For policy year ending 1976, they accounted for approximately 50 percent of all monoline product liability losses.

Mr. LAFALCE. So one ICC accounted for 50 percent of product liability losses?

Mr. NEIDICH. Monoline, that is correct. There is substantial indication that at the time the guide (a)-rate was not appropriate to compensate for those losses.

Mr. LAFALCE. Was it too much, or too low?

Mr. NEIDICH. It was substantially too low. The guide rate was $4 to $10 per $1,000, and a more appropriate rate would have been in the vicinity of $200 per $1,000.

Mr. LAFALCE. So that would mean, it seems to me, two things: First of all, if you were a manufacturer of an automobile or truck or bus, your product liability premium, assuming that the (a)-rate was being applied, might well have been lower than it should have been, but it also means that for all the other ICC's—and how many other ICCs were there other than 37101?

Mr. NEIDICH. In terms of (a)-rated, 117.

Mr. LAFALCE. It would seem to me that 116 out of the 117 would have been bearing the burden of that.

Mr. NEIDICH. They may well have been, except for the fact that they were not then actuarilly determined, nor are they now. Thus, it is difficult to judge at this point.

Mr. LAFALCE. Yes. Have you had any discussion of that issue with ISO?

Mr. NEIDICH. Only to learn and to confirm that this experience does not include the major automobile manufacturers, because their experience is rated differently.

Mr. LAFALCE. You mean when we say that ICC-37101 refers to manufacturers of autos, we are not talking about General Motors and Ford and Chrysler?

Mr. NEIDICH. No.

Mr. LAFALCE. I assumed we were.

Mr. NEIDICH. No.

Mr. LAFALCE. Are there other manufacturers of autos?

Mr. NEIDICH. Again, from our informal conversations, we don't know what was in that line. It does bear further study.

Mr. LAFALCE. I certainly think it does. One of the things that upsets me now that your task force no longer exists as of midnight, is who is going to do that type of further study?

Mr. NEIDICH. I think insofar as this is concerned, this is something that ISO is best capable of evaluating.

Mr. LAFALCE. There is no question in my mind they are best at evaluating everything you have done so far, but the reason you did it was because nobody else was doing it.

Mr. Moyer, I am really concerned about what the future is going to bring for all these unanswered questions and implementation of the answers that we have at least agreed upon.

Mr. MOYER. Our hope, of course, is in part that the publication of this kind of information will, itself, generate a continuing public scrutiny of this issue that we haven't had in the past.

This kind of report, which in many respects is truly unique, will put in the hands of insurance buyers, in the hands of consumers, and in the hands of many others, information that heretofore simply has not been available.

We hope that will generate a continuing examination of these issues.

The Congress will, of course—your committee prominently—continue an essential role, and I would encourage you not to infer that the termination of the task force is tantamount to the department or the administration turning its back on these issues. That will not be the case. There will be parts of the Department of Commerce, and also a new insurance office housed in the Treasury Department which may well get into these issues.

Mr. LAFALCE. Is that a fact? Will there be an insurance office housed in the Department of the Treasury as a matter of present fact?

Mr. NEIDICH. That was an unambiguous intention. It is not as of this moment a present fact.

Mr. LAFALCE. Is it presently a fact that there is a concrete definite plan of action with a definite date certain in the future?

Mr. SCHWARTZ. I might add a word about this also, although it may be out of date at this time. It was my understanding, as of September 1, 1980, that the organization to be established in Treasury was to be a staff. Originally, the plan had been for an office. Now the distinction between office and staff is one that is meaningful to those who are at OMB, and it might be intriguing for you to meet some of those characters. They can come over here, too. I have never been able to say that before.

Mr. LAFALCE. I don't know that they really exist.

Mr. SCHWARTZ. Since I have always dealt with them by phone, you could be right, sir.

They made a judgment that it should be only staff. They then made a judgment that no steps should be taken to implement the development of that staff during the period of time that the budget resolution was being considered.

It is my understanding that after the budget matter is resolved, OMB, working with Treasury, will develop initial steps to design and formulate this staff.

The staff's responsibilities would be much, much broader than product liability, and product liability would only be one small part

of its function. It is more an analytic function of a wide variety of insurance and labor issues that come to the doorstep of the Federal Government.

Mr. LAFALCE. It is difficult for me to understand why an insurance office would be under the Department of Treasury because their role is so limited with respect to insurance issues. Certainly when it comes to loss carrybacks or forwards, or when it comes to risk retention, I can understand.

But the issue so pervades the fabric of society, for example, as you know I am very concerned in my district about the exposure of humans to toxic substances, and the ability of those unions, my citizens, my constituents, to obtain recompense for injuries they have sustained allegedly because of that exposure. That involves insurance; it involves accident compensation; it involves maybe no-fault compensation, and I am just wondering if this is within the charge or ability of Treasury?

Mr. SCHWARTZ. That judgment was made by OMB. There is no one agency that has indepth current expertise to cover the very wide variety of liability insurance issues that can arise.

We saw that when we tried to assemble this interagency council. There are individuals, you know, but there is no nucleus of individuals in any one agency that can do it.

To that extent, OMB was operating with a black chart. My understanding—I mean it only half facetiously—is that OMB thought that Treasury would be very objective, that they could get highly qualified personnel. It is considered one of the more prestigious agencies.

We had the delusion that insurance had something to do with commerce, but I guess that was just a delusion, and it was located in Treasury.

Mr. LAFALCE. Of course, I worry about the day that Mr. Neidich might leave Commerce or the Government. I wonder whether there will then be anybody who can understand this report and be able to relate it to the outside world.

Mr. SCHWARTZ. In the Government there are those who are called civil servants. Their job is to serve person-kind, and the one man who will be extraordinarily valuable, who not only knows what is in the report but also knows what we left out, is Mr. Barrett, and he will hopefully continue in his role with the Commerce Department.

Mr. LAFALCE. I hope neither Mr. Neidich nor Mr. Barrett will leave.

We are going to take a very short break.

[Brief recess.]

Mr. LAFALCE. The subcommittee will reconvene.

Mr. Moyer, I understand that you have some time constraints. I hope to conclude this by noon, if possible. I really think most of my questions are going to be dealing with the task force report itself. So if you feel you have to take off at this time that will certainly be OK.

Mr. MOYER. Thank you, Mr. Chairman.

I might take a moment to comment on the one question you touched on earlier; namely, the extent to which the task force has addressed unsafe manufacturing practices and the response.

Mr. LAFALCE. Yes.

Mr. MOYER. There is not a companion report to that third leg of the problem and that might suggest that we have neglected that. Quite the contrary. What we have attempted to do in fashioning remedies is to preserve the incentive on the manufacturers to make more safe products, to retain whatever incentives there are to that.

We discussed the Federal Government undertaking some program to encourage safer manufacturing processes. That simply seemed ineffective and not a sensible thing to do.

What we did in developing the model law, we made certain that the incentives of the tort system remained and that incentive, more than any other single thing, goes directly to that part of the problem.

Likewise, the Risk Retention Act, by focusing on self-insurance, creates an incentive in the manufacturers to develop safer manufacturing processes so they can reap the benefits of that experience.

In this report before you today, the experience rate has the same effect to the extent that insurance practices move in the direction of taking better account of actual loss experience.

That has been a positive incentive for manufacturers as well. We have not neglected that.

Mr. LAFALCE. Mr. Moyer, I share your opinions but I do think it is important that you somehow get that point across more forcefully. I think there is a need to get that point across more forcefully so that the public at large and the business community at large realize that better ratemaking practices and better tort laws—tort laws that create incentives for making safer products—are the best way to proceed.

I don't know that we have made that connection well enough which is one of the reasons that I asked that question.

One more thing, too.

I want to comment, and take it for whatever it is worth, on your press release. I thought this task force report was really excellent, an outstanding work, but I was extremely disappointed when I read your press release concerning it.

I did not think that the press release did justice to the report.

I know you have a summary of recommendations attached to it also. But you see I don't think there are going to be more than handfuls of individuals reading this report. I doubt there are going to be more than handfuls reading the executive summary. At best they might read your page and a half press release.

I just don't think that you made the point in the press release clearly enough or forcefully enough that should be made on the basis of this fine report.

To that extent I think you have done yourself a disservice and the public at large a disservice.

It is important not only to come up with an outstanding product, which you have done, but it is important that you market that product.

The product really is a collection of insights, facts, ideas. I do not think that you have yet fulfilled the equally important part of your

responsibility, and that is adequately marketing, promulgating, disseminating information regarding the excellence of your product.

Mr. SCHWARTZ. The task force has scheduled indepth meetings with persons who are in the insurance trade press. Mr. Neidich has and will continue to do that. One of the problems with the report, it isn't a fault of the report, it is almost impossible to digest in a page and a half.

What we have done rather than rely on a press release, which we have done with prior products, is schedule personal interviews where the reporters have accommodated us to discuss the report in detail.

I think you will see in the coming month a reflection of this in the trade press.

Mr. LAFALCE. Let me give you an example of what we are talking about. We have page 1 double spaced in most part and then we get down to single. At the beginning of page 2, one sentence:

> The study also explains how, due to the relatively long time necessary to actually pay product liability claims, insurers are able to earn substantial amounts of investment income on the reserves established for these claims.

That is all you have said about investment income. Yet, when I look to this report, I think that on of the most important portions of it is the way in which the industry treats investment income and your recommendations.

It just seems to me there is a difference between the Department of Commerce in its approach and the National Insurance Consumer organization in its approach.

They would say in headlines, as they did today, "NAICO Study Reveals That Insurance Companies Are Potentially Overcharged $4 Billion."

I understand the different approaches coming from the different organizations but it seems to me that your study should have credibility. You are the representatives of the executive branch of the Federal Government. To my knowledge, this is the first time that the Federal Governent has come to the conclusion that the industry should use investment income as a means of assisting underwriters in determining what their rates or premiums should be.

I could be mistaken in that statement. I could go back to the history of the United States.

Mr. NEIDICH. FTC.

Mr. LAFALCE. FTC.

But I don't know the world is aware of that or very much of the world, if at all. It does no good—I keep telling my staff—it doesn't do any good if you know something but I am the one who has to know it because I have to be on the floor.

It does no good if you know something when the world outside must know it in order for it to make things happen the way you want things to happen.

Mr. Moyer, I know you are taking off and that is why I am jumping into this now, but it seems to me an important part of your work is still undone and that is insuring that something is done with this and that is going to require an effective—I hesitate to use the word—marketing effort.

Perhaps I should try to be more precise and say educational effort. There is a great educational effort that still must go forward.

Mr. MOYER. I think that is a point well taken. Thank you, Mr. Chairman.

Mr. LAFALCE. I was going to go into page 44 but unless you think there is something especially important, we can go on to the next recommendation, whatever your desire.

Mr. NEIDICH. Before doing that I would like to remind the chairman of Mr. Moyer's earlier remarks that the task force will be sending copies of the report to the Governors of every State, the insurance commissioners of every State as well as the key legislators of every State, so, again, that is part of what we plan to do.

Mr. SCHWARTZ. That has been a continuing practice with all of our work product so it is not as if they are getting something new or unexpected in the mail. At every legislative hearing at the State level I was pressed about the insurance ratemaking aspect of the problem. No State had the money; the skilled personnel, to devote to this report. That, I think, will assist in getting this message to the appropriate parties.

Mr. LAFALCE. Good. Thank you.

Mr. Neidich, you recommend they abolish rule 24-H rating. To be quite honest with you, I don't recall that when I was talking with ISO. What is that all about? Is that something new?

Mr. NEIDICH. No. I believe that has been around for quite some time now.

Mr. LAFALCE. Why didn't I know about it? That is a tough one.

Mr. NEIDICH. Perhaps embarrassing.

This is an exception to the applicability of manual rates and in essence what it provides is if a risk is generating at basic limits rates in excess of $1,000 product liability premium, then the excess over the $1,000 shall be (a)-rated. In effect that gives an insurer great discretion for a risk which would otherwise be manually rated.

It appears unwarranted as the report explains.

Mr. LAFALCE. Give me that again.

Mr. NEIDICH. If a risk is generating a premium in excess of $1,000 at basic limits rates—manual rates—then the excess over $1,000 shall be (a)-rated.

Mr. LAFALCE. Why should that be? What is the rationale for this?

Mr. NEIDICH. I don't know. That is part of the reason we recommend it be discontinued.

Mr. LAFALCE. What percentage of risks are rated in this manner?

Mr. NEIDICH. That was beyond the scope of our study. It is a rating technique available in the ISO manual.

Why don't we jump to No. 9 now?

Mr. LAFALCE. All right. Fine.

Mr. NEIDICH. Revise the present scheme of schedule rating to include categories more suitable for product liability insurance.

If you turn to page 56 you will see the present categories of permissible schedule modifications. As is apparent, these schedule

modifications are intended to be used for coverages significantly different than product liability insurance.

One would have a difficult time applying many of these modifications to a risk for product liability insurance because they would have no real application to the safety or lack thereof of a particular product.

This is saying ISO should devise schedule modifications which more appropriately are applicable to product liability risk.

It would also be appropriate, I think, to consider items 10 and 11.

Mr. LAFALCE. Let's stick for the present with No. 9. Of what value is the present scheme of schedule rating if the categories are so ill-suited to product liability insurance?

Mr. NEIDICH. They provide underwriters with some flexibility in deviating from manual rates; I think the application of many of these modifications would be tenuous which brings us to items 10 and 11.

Item 10 says: "Abolish the $1,000 threshold presently in effect for schedule rating."

It is saying all risk should be capable of schedule rating and recommendation No. 11 is saying if there are going to be adjustments made to manual rates, other than via experience rating, the adjustments must be made via schedule modifications. Assuming a revision of the schedule, greater equity would be promoted for the reason you would start with a manual rate and the underwriter would have a reasonable guide from which to make deviations from the manual rate. I believe this could potentially be helpful to the underwriters themselves.

Mr. LAFALCE. Fine.

Mr. NEIDICH. Why don't we jump to No. 17 at this point?

Mr. LAFALCE. Do you think that item No. 14 then is worth discussing?

Mr. NEIDICH. No. 14 recommendation is to investigate the feasibility of promulgating rates on an accident year basis or a basis of a period consisting of one-half of a policy year.

Again, it is a direction for ISO to engage in further study. This is in part prompted as a result of the considerable length of time that it presently takes for a policy year to conclude reporting as well as the time involved for ISO to analyze and put the data in an appropriate form.

This has been known to take as long as 4½ years from the beginning of a policy year; it would seem there is a need to have as current information as is practical.

On the other hand, again as the report discusses, an accident year methodology is not anywhere near as accurate as a policy year methodology. Hence, it may be appropriate, instead of using a whole year as is presently the case, to bifurcate the policy year and undertake accounting on the basis of a half policy year.

This is an investigatory suggestion only.

Mr. LAFALCE. I understand.

Where did you want to jump to?

Mr. NEIDICH. No. 17. Recommendation 17 is: "ISO should investigate the appropriateness of more suitable mathematical functions in developing its basic limits trend factors."

Presently they use a strictly mathematical function both to predict their exposure trend factor, which is an estimate of inflation, as well as increases in losses over time.

Mr. LAFALCE. Where is this?

Mr. NEIDICH. This is pages 103 through 108.

Mr. LAFALCE. That corresponds with some questions that I have. I was intrigued with chart 1, page 106. You have a large loss ratio and rate adjustment shown and you do it by number of quarters and number of years. It seems to me, Mr. Neidich, that depending upon the number of quarters that ISO would use and depending upon the number of years that ISO would use would determine the result and that you could almost produce the result that you wanted by using a certain number of quarters or using a certain number of years.

I would ask for you to expand upon my interpretation of that, No. 1, and, No. 2, I would like to know if there has been, to your knowledge, consistency or inconsistency on the part of ISO in its use of numbers of quarters and numbers of years.

No. 3, one of the problems that I have is it seems to me that what you have presented here in chart 1 in the explanation is ISO is looking to the past in order to determine the future, rather than using indicators which would be more likely to be determinative of the future than past indicators that they are in fact using.

Would you care to comment?

Mr. NEIDICH. First, let me state at the outset, to the best of our knowledge, ISO has been consistent in its use of the years so there is no attempt on their part to obtain the desired result by manipulating the data selection points.

Mr. LAFALCE. Fine. What has been their base?

Mr. NEIDICH. They have been using 6 years of loss data in arriving at their trend factor and using 12 quarters of consumer price index data in arriving at their offset trend figures.

Mr. LAFALCE. From your model, they have been using the maximum number going back as far as they could.

Mr. NEIDICH. What we did was truncate their data at various points on the inside.

Mr. LAFALCE. What is it they are attempting to develop here?

Mr. NEIDICH. An estimated projection of both future losses as well as future sales for their offset trend factor.

Mr. LAFALCE. Going back 12 quarters in computing exposure to trend factors and going back 6 years in computing trend factors might be more misleading than using much more recent data.

Mr. NEIDICH. It might very well be.

We do not judge the phenomenon here but we note that the selection of data points in the ISO methodology is important and does dramatically affect the indicated results.

Mr. LAFALCE. Can you show how it does affect the indicated results?

Give me some extreme examples.

Mr. NEIDICH. If ISO were in fact to use 1 less year in taking into account losses and use 12 quarters in its offset trend factor, it would come up with an aggregate rate increase of 11.6 percent which is higher than that which they did when they used 6 years of loss data.

On the other hand, if they were to use as few as the 3 most recently available quarters of CPIC data and 3 years of loss data, they would come up with an aggregate rate decrease of 31.3 percent.

Mr. LAFALCE. What about if they were to use the last 12 quarters and 3 years?

Mr. NEIDICH. They would come up with a rate decrease of 24.9 percent.

Mr. LAFALCE. So really they have come up with figures which indicate plus 7.4 percent but unless there is some compelling reason for using 12 quarters and 6 years, they could just as easily have used some other time?

Mr. NEIDICH. I think the compelling reason on their part is their desire for consistency in methodology. So that results will not change dramatically from one year to the next. I believe they should be looking into the future and should be concerned with finding the best parameters to make those future projections.

Frankly, I think the type of analysis they are using via the 3 quarters or 12 quarters insofar as the exposure trend factor is concerned, is inappropriate, given the fact that you have numerous sophisticated econometric models that are designed to do just that. Here they are using what in effect is nothing more than a simple statistical methodology to make this projection.

Mr. LAFALCE. This to me seems damning of ISO's methodology. This is not a modest criticism. It seems to me that this goes to the guts, if you will, of their methodology.

Mr. NEIDICH. I think part of the reason that leads one to say that—again, without necessarily agreeing with that—in the last couple of years of double-digit inflation does produce divergent results such as this. However, it is a methodology that has been used for a considerable period of time.

Nevertheless, given double-digit inflation, it certainly seems a revaluation is warranted.

Mr. LAFALCE. One's initial thought might be that double-digit inflation might necessitate the insurance companies increasing their premiums more so than in the past. On the other hand, upon analysis I am not sure that is correct. Upon analysis, I tend to conclude that the more the inflation, perhaps the less their rate should be. What is your judgment on that?

Mr. NEIDICH. Why don't we focus on the manner in which basic limits rates are made. What is involved is a computation of estimated future losses over estimated future premiums. In making the estimate of losses they compute a trend for losses. In making an estimate of future premiums, they make an estimate of the rate of inflation for sales.

So if one trend is greater than the other trend, then that would skew the results.

Specifically, if the rate of inflation for sales is less than the rate of inflation for losses, everything else being equal, that would indicate a rate increase is warranted.

However, if the rate of inflation used in the trend factor for sales is greater than the rate of inflation used for losses, then it would indicate that a rate decrease is indicated. There is a relationship between the two of them.

At the present time, ISO is using for bodily injuries an inflation rate for losses of 14 percent and an inflation rate for sales of something on the order of 5.8 percent.

Mr. LAFALCE. That seems to me almost directly designed to skew the results to higher rates. Would it not?

Mr. NEIDICH. That is certainly an understandable interpretation of that.

Mr. LAFALCE. What is the justification for using a different inflation rate for losses and a different inflation rate for sales?

Mr. NEIDICH. They arrive at that because they are using different data bases in making the computation. For losses they are looking at their loss experience and for inflation they are looking at the consumer price index for commodities.

Mr. LAFALCE. Yes; but inflation has been more than 5 percent and inflation for sales has been far more than 5 percent, and any econometric model that I am aware of would say that inflation in the next 5 years is going to be at a rate far in excess of 5 percent.

It would seem to me that the higher the inflation rate for sales, probably the lower the insurance rate should be.

Mr. NEIDICH. If you look at the chart on page 101, the hypothesis is borne out as the number of quarters deemphasizes the historic and moves more current, regardless of the number of years used you will see that the chart shows that the indicated rate increase either decreases or in effect becomes a rate decrease. So that is certainly true.

Mr. LAFALCE. Again, I don't see any of that in your press release. I don't see it presented to the public in an intelligible fashion at all. This is crucial and I think we somehow have to improve the presentation of the salient points of this report.

Mr. NEIDICH. I agree. I feel compelled to observe that the concepts we are talking about are difficult concepts for the public to digest.

Mr. LAFALCE. I understand that but we must make that attempt and I do not think that thus far we have even attempted the attempt.

Mr. NEIDICH. Chart 1 presupposes the use of a purely mathematical model when what ISO is seeking to do is make an estimate of the future. I think it is important not only to use past data to the extent it is appropriate and available but not to lose sight of what we are doing, and to also use external data in coming up with these future projections.

Mr. LAFALCE. Which calls for an even greater educational effort. They have to use external data regarding, it would seem to me, projected GNP, et cetera, and there is a divergence of opinion according to what econometric model you would use. However, I don't think the divergence of opinion among the econometricians or magicians is as great on average as the—I think they would be much closer amongst themselves than to reality, whatever that reality is going to be, and only foresight will let us know that.

Then the projection based upon the past 12 quarters and the past 6 years seems to me to have almost no foundation for making future projections.

Let's go on. Which recommendation do you want to discuss next?

Mr. NEIDICH. I think No. 19 should be mentioned, that ISO should remove all expense and profit-loading provisions from their ratemaking analysis.

This is a discussion that takes place on pages 108 through 112. Essentially as your subcommittee in the 95th Congress described in its report, in the ratemaking process ISO builds in certain expense profit loading provisions. It builds in 25 percent for production costs, 10 percent for general expense allowance, 3 percent for taxes, licenses and fees, and 5 percent underwriting profit provision.

These are in effect industry averages or something akin to that, whereas, the actual amounts expended for each of these items may vary from company to company. Nevertheless, insofar as ISO is promulgating manual rates, each company is being furnished with a rate on the basis of industry averages.

It would seem more appropriate for ISO to balance losses with projected premiums, leaving it for the individual companies to build into their manual rates their own unique requirements for these items.

That would not be an overly cumbersome process for the company.

Mr. LAFALCE. Do we have any analysis of the difference that might exist or does exist amongst the different insurers?

Mr. NEIDICH. No; we don't.

Mr. LAFALCE. All right.

Mr. NEIDICH. We also make this recommendation in the context of (a)-rating.

Mr. LAFALCE. Which one?

Mr. NEIDICH. No. 19.

At this point I want to jump to the recommendations for the insurers.

Mr. LAFALCE. Just a minute now. I think we would be remiss if we did not discuss excess limits.

Mr. NEIDICH. Yes. May I suggest that we discuss this in the context of what State regulators should do. I think it might be easiest to handle at that time.

Mr. LAFALCE. All right.

Mr. NEIDICH. I think that insofar as our recommendation to insurers is concerned, this is certainly one of our most valuable contributions of this report because it provides a means whereby the report can be used by those other than in Government and in the industry.

Specifically we recommend in recommendation 2 that the underwriting file reflect and that the individual insurance purchaser be advised of in effect how his rate is determined and of the modifications, if any, that have been made and why they have been made.

I think that this recommendation, together with this report, provides a blueprint for any purchaser of product liability insurance who believes that he is not being fairly treated to be able to understand whether that is in fact the care.

For example, at present you are a business and get a rate that it is $2 per thousand. When questioned why, the insurer says "because." This recommendation would require an insurer to explain its starts with an (a)-rate of $1, and, because it believes you are an

above average risk because you have a lot of products on the market, modifies the rate to $2.

It would provide that business an opportunity to dispute that because it now knows what the insurer is thinking.

Mr. LAFALCE. Aren't the independent agents already performing the valuable service for their clients?

Mr. NEIDICH. It does not appear that this is done to a substantial extent.

Mr. LAFALCE. All right.

Mr. NEIDICH. Again, with the recommendation for a schedule modification. If a manual rate is applicable, it gives a business an opportunity to see whether it has received an experience modification if one is warranted, and if it has received a schedule modification if that was warranted.

Mr. LAFALCE. Basically, as I understand this recommendation, you are simply saying insurance companies do what you will, but whatever you do, explain it to your customer.

Mr. NEIDICH. Precisely.

Mr. LAFALCE. You are calling upon them to disclose to their customers the reasons for their decisionmaking process.

Mr. NEIDICH. Exactly.

Mr. LAFALCE. Do you think this is too large a burden? Do you think that this is beyond the capacity or too unreasonable to be shouldered by the insurance company, the insurance agent, the broker, whoever might be relating to the client?

Mr. NEIDICH. I can see disclosure of this type taking less than one page. Given some of the disclosures or at least workups that are present in the life insurance industry, I would think this would be a lot less involved than detailed tables that are often provided purchasers.

Mr. LAFALCE. Assume that a certain period of time went by. Assume, for example, that 6 months or so transpires and no insurance company heeds your suggestion, although they are unable to come up with good reasons for not heeding it.

Do you think then that State regulators should consider promulgating rules requiring such disclosure or State legislators should consider legislating such disclosures, or that the FTC should consider promulgating a regulation requiring such disclosures? Or that Congress should consider legislation?

Again, we have those four alternatives but I say only after the insurance companies themselves are given the opportunity to either explain why that would be impossible or to comply with it.

Mr. NEIDICH. I would analyze—that as follows it may seem cumbersome but is required because of the competing spheres of State and Federal governments—if the insurers are not willing to adopt this by themselves, in the first instance perhaps State regulators should require them to do that.

If the regulators for some reason are unwilling, then the State legislatures could make that a requirement. If that does not appear happening, at such a time I would have to say it would not be inappropriate for Congress to do so.

Mr. LAFALCE. I think that is a fair statement and a very fair approach. Of course, what would be preferable would be for the

insurance companies to act of their own volition and make moot the necessity of going any further.

Mr. NEIDICH. There is no reason they can't do that of their own initiative.

Mr. LAFALCE. Let us continue.

Mr. SCHWARTZ. On that point, Mr. Chairman, we sense in looking at developments in the Risk Retention Act, something within the industry that seemed less true when you held your first hearings. There have been divergent views within the industry itself on the act where originally there was kind of a monolith against it.

When you held your first hearings you heard a series of echoes. Everybody was always saying the same thing. It was almost one piece of testimony passed around and a word or two was changed but there was almost identical comment.

This seems less true in the industry today. For that reason I have some optimism that you will not see a uniform negative response to these recommendations, that you will see a diversity in how they are treated.

Mr. LAFALCE. I hope you are right.

Mr. Neidich, please continue.

Mr. NEIDICH. The remaining recommendations for insurers really are nothing more than complements to items we have discussed earlier. Why don't we flip now to what State regulators should do, specifically No. 3, and consider the excess limits.

Mr. LAFALCE. All right.

Mr. NEIDICH. In terms of what we learned——

Mr. LAFALCE. The recommendations on page 3 in conjunction with recommendations on page 2 are with respect to the items 21 through 23.

Mr. LAFALCE. What are the corresponding pages in the report?

Mr. NEIDICH. On page 4, item 3, we are speaking of pages 116 through 119.

Mr. LAFALCE. On page 2, items 21 through 23.

Mr. NEIDICH. Beginning on 113 through 117.

Mr. LAFALCE. Mr. Neidich, could you provide to our staff the corresponding pages to all of your recommendations?

Mr. NEIDICH. Surely.

[The information follows:]

CONCLUSIONS AND RECOMMENDATIONS

As the following report reflects, we have made a number or recommendations for improvements in product liability ratemaking methodology. This section will cull these recommendations from the report and allocate responsibility for their implementation among ISO, insurers, state regulators, the NAIC, and state legislatures. In making this allocation of responsibility, we do not intend to derogate from the state regulator's responsibility for implementing virtually all of these recommendations, nor from the state legislatures functions. The allocation is intended merely to clarify which of the parties' action is necessary to effect the indicated changes.

A. *Insurance Services Office* should:

1. Amend its present classification scheme to one which uses the standard industrial code methodology to five digits. (pp. 32–37)

2. Determine its (a)-rates actuarially which in the aggregate reflects the projects loss experience of all (a)-rated classifications. (pp. 40–45)

3. Determine (a)-rates without regard to expense and profit loading. (p. 47)

4. Provide for each classification a range of (a)-rates which represent the average rate for the average risk. (p. 47)

5. Require that present ICC 37101 (manufacturers of autos, trucks, and buses) not be included in the actuarial determination of (a)-rates, and should be treated separately. (p. 45)

6. Abolish Rule 24H rating. (pp. 50–51)

7. Continue experience rating at a $2,500 threshold. (p. 53)

8. Use experience rating to the extent credible for all risks presently eligible. (p. 55)

9. Revise the present scheme of schedule rating to include categories more suitable for product liability insurance. (pp. 55–58)

10. Abolish the $1,000 threshold presently in effect for schedule rating. (p. 58)

11. Make all adjustments to manual rates (other than experience rating) through the application of schedule modifications. (p. 58)

12. Require the reporting of schedule modifications and periodically test them for their actuarial accuracy. (p. 57)

13. Collect and review detailed product liability data from large (a)-rated classifications and loss rated classifications on an experimental basis. (p. 98)

14. Investigate the feasibility of promulgating rates on an accident year basis, or alternatively, on the basis of a period consisting of ½ of a policy year. (pp. 99–100)

15. Study the loss development procedure for basic limits rates to ascertain whether review on the basis of industry group or size of risk might yield more equitable results. (p. 102)

16. Include in its claim counts those claims where allocated loss adjustment expenses only were incurred. (pp. 102–103)

17. Investigate the appropriateness of more suitable mathematical functions with respect to its basic limits trend factors. (pp. 103–108)

18. Evaluate such trend factors in light of expected future conditions, external to the data used in their derivation. (pp. 104–105)

19. Remove all expenses and profit loading provisions from their ratemaking analysis. (pp. 108–112)

20. Introduce severity considerations in the credibility analysis at the sub-group level. (p. 113)

21. Empirically validate the combining of (a)-rated experience and manually rated experience for purposes of the excess limits tables. (p. 114)

22. In its derviation of the excess limits tables, stratify losses valued above $300,001. (pp. 16–117)

23. Derive a trend factor applicable to fully developed losses, rather than the immature 27 month leases with respect to the trend factor used excess limits factors. (p. 117)

24. Collect data necessary to ascertain the payout rate of product liability claims. (pp. 141–142)

B. *Insurers.*

1. When employing (a)-rates, the underwriting file should reflect:

a. If the rate employed with respect to a specific risk falls within the proposed guide range, the reasons that the high or low end of the range was used. (pp. 47–48)

b. If the rate charged falls outside the guide range, each of the reasons warranting the use of a different rate and, to the extent feasible, the impact each such reason has on the overall deviation. (pp. 47–48)

2. The information recommended to be included in the underwriting file pursuant to recommendation 1, supra, should be made available to each prospective risk prior to the issuance of any policy. (pp. 47—48)

3. Insurers should also:

a. Load their own particular expenses and profit requirements into ISO's actuarially determined guide (a)-rates. (p. 47)

b. Use schedule modifications for all manually rated risks to take into account deviations that particular risks may have from the norm. (p. 58)

c. Memorialize schedule rating adjustments as part of the underwriting file. (p. 58)

d. Provide prospective insureds with a statement of the reasons for the schedule modifications and the extent of same. (p. 58)

e. Build into the ISO published manual rates their own particular expense and profit requirements. (pp. 108–112)

C. *State Regulators* should:

1. Assure that all the foregoing recommendations are implemented.

2. In reviewing a basic limits rate filing:

a. Review the loss development exhibit for indications of reserve strengthening for various reporting periods, and require the use of an appropriate mean development factor to take such reserve strengthening, if present, into account. (pp. 100–102)

b. Review the effect that ISO's data points have in the computation of the trend factors and on the overall rate adjustment. (p. 105)

3. In connection with the excess limits filing:
a. Review the validity of the Pareto curves used as estimators. (p. 116)
b. Review the number of data points used in computation of the trend factor. (p. 117)
c. Require the filing of separate exhibits for the development and for the trending of allocated loss adjustment expenses. (p. 118)
d. Require the submission of sufficient materials to validate the computer simulation used in the construction of increased factors limits tables. (p. 119)
e. Determine, with respect to particular insurers, the appropriateness of factors provided for underwriting profit in view of investment income, computed in a manner which will reflect the compounding of income. (chapter 8)
D. *The National Association of Insurance Commissioners should:*
1. Coordinate the implementation of the recommendations made with respect to state regulators.
2. Amend the product liability supplement to the annual convention statement as follows:
a. Compute adjusted investment income in a manner which more equitably includes only those items of expense attributable to invested assets, and which includes gain or loss from the sale of bonds and real estate. (pp. 156–158)
b. Compute investment income allocable to product liability on a compounded basis, taking into account investment income attributable to prior periods as appropriate. (pp. 158–159)
c. Employ an accounting method which more accurately matches loss expenses with receipts. (pp. 154–156)
d. Require the reporting of case reserves established for known claims. (pp. 162–163)
E. *State Legislatures* should:
1. Repeal state product liability reporting laws, assuming the state uses the NAIC product liability supplement, as amended with recommendations proposed herein. (Chapter 10.)

Mr. NEIDICH. Excess limit rates are made in a very different fashion than are manual rates. In the case of manual rates, ISO takes actual losses and makes adjustments to those, but always using actual dollar losses. In the case of excess limit rates, what they first do is classify them into ranges, and arrive at a loss severity distribution. Pages 84 to 84-A, illustrate the type of loss severity distribution they make.

After they do that, what they do is fit two functions to these distributions, and that is the last time they ever look at actual dollar losses. The remainder of the computations for the excess limits are with numbers taken from these functions, which is why the validity of function becomes of paramount importance. In fact, to the best of our knowledge, no regulator has ever looked at the validity of these functions, nor have we, as that was beyond our staff capabilities.

Mr. LAFALCE. Would you go over that once more?

Mr. NEIDICH. I think it is easiest to compare it with how basic limits and losses are made. They are always using actual dollar losses in the various computations made. In their determination of excess limits factors, however—to overly simplify, these average losses, are merely plotted onto a curve.

Mr. LAFALCE. Is this the Pareto curve we are making reference to?

Mr. NEIDICH. Yes, the plottings will not result in a continuous curve—these are real numbers and they never fall as nicely as assumed numbers—what they do fit is a Pareto curve.

Mr. LAFALCE. What is a Pareto curve?

Mr. NEIDICH. A mathematical function.

Mr. LAFALCE. Sort of like the Laffer curve?

Mr. NEIDICH. I would hope it is more valid than I understand that is.

Mr. LAFALCE. I understand the invalidity of the Laffer curve. Is there much more validity?

Mr. NEIDICH. The various State insurance commissions will have to evaluate that. I do know this procedure appears to have become very prevalent in the making of excess limits rates generally.

Mr. LAFALCE. Are we saying, that the determination of excess limits is in large part based upon the fictions that are created by the insurance industry?

Mr. NEIDICH. Presumably the curve they are creating has a strong correlation to these actual losses. Again, that test, to my knowledge, has never been made outside of ISO.

Mr. LAFALCE. Has no insurance regulator evaluated that?

Mr. NEIDICH. The State of New Jersey held a hearing and did not request information that would enable them to make this determination. This exhibit, frankly, is one of two exhibits furnished to the State of New Jersey. However, the computation of the excess limits factor would involve 10 exhibits like this, so if New Jersey only received 2, it was really impossible for them to validate the use of the function.

Mr. LAFALCE. What conclusions do we draw from this?

Mr. NEIDICH. Not to create a misimpression, to the extent we understand what they are doing, it makes sense logically. Whether, in fact, the margin of error inherent in the procedure, is sufficient to warrant the rates, however, remains an unknown. In the same connection, I think it is important also to consider item 3(D). The excess limits table requires an assumption of frequency, and what ISO has done is create a computer simulation to estimate frequency, so that these tables can be generated. To the extent we are aware, no State regulator has ever been provided with that computer model to see whether what they are doing is, in fact, appropriate.

Mr. LAFALCE. How important are excess limits in the total scheme of the ratemaking process?

Mr. NEIDICH. Not so much in the ratemaking process but I would suspect very few purchasers content themselves with the purchase of basic-limits coverage. That coverage is for bodily injury, $25,000 per person, $50,000 in the aggregate.

Mr. LAFALCE. Any business, of course, is going to go way beyond that.

Mr. NEIDICH. Certainly.

Mr. LAFALCE. So small businesses and large businesses, in large part, are dealing with excess limits?

Mr. NEIDICH. That is correct.

Mr. LAFALCE. What you are telling me is that the determination of the rates for excess limits——

Mr. NEIDICH. They are, in fact, multiples of basic limits rates.

Mr. LAFALCE. The determination of the multiple is based upon a data base and a computer simulation and an economic theory that to your knowledge has never been validated by any State regulator or any entity other than the one coming up with it, ISO. Is that correct?

Mr. NEIDICH. ISO and its participating insurers. I think this work does involve several of their insurance companies. Again, I would like not to create the impression what they are doing is wrong.

Mr. LAFALCE. We don't know.

Mr. NEIDICH. We don't know. That is all I am saying. What they are doing makes sense. Whether it, in fact, works, is beyond the expertise of the Department of Commerce, and, curiously, the one State where they tried to look into this area, they didn't ask any of the right questions.

Mr. LAFALCE. Maybe in the future we can ask some of the right questions.

There is something else I would like you to note, if you will. I am presently contemplating hearings, as I said earlier, with ISO and insurers and State regulators, et cetera. I may split them up, but I think it would be helpful to me if you could also plan to testify on each and every occasion when anyone else testifies.

Mr. NEIDICH. Certainly.

Mr. LAFALCE. And then perhaps during the question-and-answer period, you might also have point/counterpoint.

Shall we continue?

Mr. NEIDICH. Why don't we take item 3(e) on page 4. That is: State regulators should "determine with risk particular insurers, the appropriateness of factors provided for underwriting profit in view of investment income, computed in a manner which will reflect the compounding of income.

Mr. LAFALCE. What pages would that be?

Mr. NEIDICH. That really brings us to the investment income section. We are talking about chapter 8, which begins on page 129.

Mr. LAFALCE. All right. What points would you like to make with respect to that?

Mr. NEIDICH. First, that the ISO ratemaking methodology does not take into account investment income. It does build into the ratemaking process at present a 5-percent underwriting profit. Again, if our earlier recommendation in this regard were heeded, ISO would not be building in an underwriting profit so that that problem would be obviated.

In chapter 8, we, in effect, created a simulation to get some feel for the magnitude of the investment income that was potentially earned by the insurance industry.

Mr. LAFALCE. You have come up with a model? Is that what you are referring to?

Mr. NEIDICH. Yes.

Mr. LAFALCE. On what page is that?

Mr. NEIDICH. The narrative description of the model begins on page 131.

Mr. LAFALCE. All right.

Mr. NEIDICH. This lays out the assumptions we have made.

Mr. LAFALCE. Yes.

You have a number of different charts, particularly 133, 134, and 135.

Mr. NEIDICH. Part of our most important finding is not they are making potentially x or y dollars, but because of the delayed time in paying out these amounts, they are potentially earning a sub-

stantial amount of investment income that must be taken into account when considering underwriting losses, and that it is not appropriate to disregard these amounts.

Mr. LAFALCE. Why do you say they must be taken into account when considering underwriting losses?

Mr. NEIDICH. If I might, I will illustrate three different ways of accounting for the investment income. Let's disregard items of expense and just talk about losses.

Say that an insurer sets aside $57 in a bank account and every year it earns interest. He takes that interest that it earns and puts it in his pocket and doesn't use any of it to pay losses, and pays losses just out of the bank account.

When it exhausts the $57 dollars, it will say there is an underwriting loss; they have forgotten about all the money they have put in their pocket in the meantime. That historically is how investment income has been treated.

More recently, there has been an ameliorative trend, and the recently implemented NAIC product liability supplement reflects this trend. They now take into account some of the investment income, and they do that in this fashion.

Again, considering our bank account, they start with $57 in the bank account. Every year they take the interest on the bank account out, but instead of putting that in their pocket, they put it in another bank account.

Mr. LAFALCE. Do they charge that against losses?

Mr. NEIDICH. No. What they do is they count only the $57 in the bank account and the deposits in the second bank account, say x dollars; the difference between what they have paid out and $57 plus x is claimed as an underwriting loss.

What they fail to take into account is the income attributable to the income that they have set aside.

Mr. LAFALCE. It seems to me what you are saying is that they have only done this just recently——

Mr. NEIDICH. This is recent; right.

Mr. LAFALCE [continuing]. That they are taking the income from product liability premiums and counting that, but only on the basis of the income from 1 year, the first year, and that all future income from the premium and the income from that first year will not be counted. In other words, they are not considering the compounded income.

Mr. NEIDICH. Essentially that is correct. They are not considering the compounded income.

Mr. LAFALCE. What would be the rationale for considering the initial year's income but not the compounded income? Is there any? It seems to me that is devoid of reason. Once you make that step to use investment income, then you must use the totality of investment income, and that would mean compounded income.

Mr. NEIDICH. From what I gather, the entire issue of investment income and accounting for investment income has been a debate which has raged for many years now, which may account for the recent NAIC supplement providing what it does.

In product liability insurance—the ISO closed claims survey has demonstrated it is not until approximately 3½ years after the premium is collected that half of all losses are paid—the insurer

has a considerable time with which it holds money to pay future losses on which it earns substantial sums of investment income in the early years.

Our model has flaws—technical weaknesses—in it, so while we would be reluctant to say x dollars or y dollars are possible, the model is valid to ascertain there is a substantial sum of investment income being earned as a result of what we have seen.

One of our recommendations is for ISO to collect information that would enable it to compute payout tables which would, in turn, enable individual insurers to make projections of what their likely investment income is. This, in turn, can be used for their own purposes in determining their required underwriting profit, which, pursuant to the earlier recommendation, they would be building into rates on an individual basis.

Mr. LAFALCE. I think I understand that. I think I would concur wholeheartedly with that.

Is there going to be any attempt on the part of the Department of Commerce to meet with ISO, to meet with the insurance companies, to meet with NAIC to encourage them to do this, or are we merely going to send them the reports and say, go, ye, therefore?

Mr. NEIDICH. I think the professor could better respond to that.

Mr. SCHWARTZ. Your suggestion would be conveyed to Mr. Moyer, because Mr. Moyer is an appointee of the President and can make that decision.

Mr. NEIDICH. What I was going to point out was that the task force has, through its existence, cooperated with all seeking its assistance and input, so if ISO requested our assistance, we would cooperate with them.

Mr. SCHWARTZ. Mr. Moyer didn't note this, but for the record they will be continuing at the Department of Commerce and will be developing a study on oil pollution insurance, a related area, and their services are with the Department for the foreseeable future.

With regard to other meetings, that is a judgment that Mr. Moyer would have to make, and the best thing to do is convey that to him.

Mr. LAFALCE. Fair enough. I hope you will convey this to him, Mr. Neidich, with my encouragement and exhortation.

It is 12 o'clock, and my time is running short. I think we ought to point out about the NAIC reporting form and its deficiencies. We have done this somewhat, but not explicitly.

Mr. NEIDICH. The NAIC has recently promulgated a special product liability supplement to the annual report, which is reproduced in the appendix. It requires extensive information, some of which is more useful than others, and, again, it attempts to account for investment income.

We have reviewed part of the weakness in their doing so. Additional deficiencies, if you would have it, is that they exclude certain types of income in making that computation, types of income which appear questionable. We recommend that that be revised. I think it is important to note that the NAIC supplement, though, is probably not especially useful for insurance regulators, in any event.

An insurance regulator has two principal functions: One, to assure the fairness of rates, and two, to assure the solvency of insurance companies. The product liability supplement does not provide additional information which would enable an insurer to better fulfill those functions.

The supplement is potentially useful to some extent to State legislators and to Congress in that it could provide some indication of the profitability of writing product liability insurance.

Again, part of the difficulty there, in addition to the investment income problem, is the accounting methodology that they use: The accounting is not done on a policy-year basis.

You see, a policy written this year will not finally pay out all losses until many years hence. Since the accounting method of aggregates all the experience, it is very difficult to find out current profitability.

With those remarks I think it is also appropriate to note that many of the special State reporting requirements—19 legislatively and one State which adopted a requirement administratively—require special product liability information to be reported. Virtually all of this information is irrelevant to the insurance commissioners for the reasons the NAIC schedule is deficient, and is of virtually no use to the legislators because it doesn't provide the type of information that is necessary to determine profitability.

Mr. LAFALCE. I did notice, though, that you had praises for one State, at least, and that was the State of Kansas. I also notice that recommendation 2-D for NAIC you say they should require the reporting of case reserves established for known claims.

Isn't that what Kansas did in essence? Isn't that what you are recommending the NAIC should promulgate for all States?

Mr. NEIDICH. Yes. Kansas was unique in requiring on its report three questions. They wanted to know: One, what paid claims had initially been reserved at, two, what the reserves were for these claims immediately prior to disposition, and three, what was actually paid with respect to them.

For 1977, which is the latest year available, it showed that paid claims initially were reserved at $2.4 million. Immediately prior to the time of disposition they had been reserved at $2.9 million, and that the amounts actually paid with respect to that was $1.03 million, indicating substantial overreserving.

But, again, the experience is relatively small. While certainly no nationwide inference can be drawn, further information in this area may well be useful.

Mr. LAFALCE. Is that information in the report?

Mr. NEIDICH. That is on pages 162 through 163.

Mr. LAFALCE. All right, good.

I was reading the Journal of Commerce report of your press conference last week in which they state that you said that there were three basic inequities in current insurance ratemaking for product liability. I don't think that you have discussed that today.

Mr. NEIDICH. I think that is something of a misquote. Inherent in the process are potentially three inequities, which the underwriting process provides an opportunity to mitigate. Those are what we refer to in the report as the safe product dilemma, which briefly is that since premiums——

Mr. LAFALCE. Are these included in your conclusions and recommendations?

Mr. NEIDICH. They are not really conclusions or recommendations because presumably they are being addressed in underwriting. We only note them——

Mr. LAFALCE. Shouldn't the insurers make specific attempts to adjust the underwriting process so that these potential inequities do not become inequities?

Mr. NEIDICH. Yes; they should.

Mr. LAFALCE. And if this is important to give such special attention in your press conference last week, it seems to me that it would have been better if they were included in your recommendations for insurers.

Mr. NEIDICH. Yes.

Mr. LAFALCE. So do what you are doing, if you are doing it, but if you are not doing it make sure you do it.

Let's talk about what the potential inequities are first. I suspect that they are not doing it, and I suspect they are not adjusting adequately for the potential inequities of the ratemaking process.

Mr. NEIDICH. This is pages 126 through 127 of the report. Safe product dilemma essentially arises out of the fact that generally premiums are a function of sales volume. If we were to consider two manufacturers, each with an equal sales volume of two generically similar products. However, one product was more expensive as a result of increased safety features. Then by strict application of the rating technique, the manufacturer of the safer product—as a result of his increased sales volume—would pay a higher premium than the manufacturer of the less safe product, which is patently absurd.

To illustrate the long-life product dilemma, consider a manufacturer who has just opened his doors and a manufacturer that has been around for 20 years both making a product that survives on the marketplace for 20 years. If they each produce an equivalent volume and sales dollars for a given year, a strict application of rating technique would indicate the two of them warrant the same rate when in fact the two——

Mr. LAFALCE. You are hurting the new startup businessman?

Mr. NEIDICH. It may.

Last is the multiple product inequity.

Mr. LAFALCE. I am really concerned about this one.

Mr. NEIDICH. This does exist and this is not being mitigated by the underwriting process.

Mr. LAFALCE. This is not a potential inequity, this is an inequity which the underwriting process could accommodate but in fact has not accommodated?

Mr. NEIDICH. Right. That occurs in cases where you have a single manufacturer or product seller who is rated pursuant to multiple product classifications. When this is done, they apply the exposure to the rate for each of these different classifications, after which each indicated product is summed to yield the total product liability premium. This purchases a single product liability policy.

However, what is being paid for is several product liability policies, so in effect the product manufacturer is being shortchanged. There is an illustration of how this works on page 126.

Mr. LAFALCE. I see, No. 3. Could you give that example to the public at large, to the trade presses?

Mr. NEIDICH. I could read it, which is probably the easiest way:

If you consider a company—EF—which manufactures two products, E and F, with a sales of $1 million each for each of the two products. If the applicable to product E is $E per $1,000 sales, and the rate applicable to F of F Dollars per thousand sales, then a basic single limit premium would be 1,000 (E+F). This would purchase a single policy with aggregate policy limits of $25,000 with an occurrence limit of $25,000 and an aggregate limit of $50,000.

If company EF were to have aggregate losses with respect to produce E of $50,000, and aggregate losses with respect to the product F also in the amount of $50,000, the policy would cover only $50,000 of losses, since the aggregate limit would have applied. Thus the company would be out of pocket $50,000 on account of its loss experience.

If company EF in effect divided into two operating subsidiaries, and each subsidiary was able to purchase its own insurance, then the total premium for the two companies would be unchanged. However, with the same loss experience, the total loss would be covered and neither company would be out of anything, out of pocket any amount.

Mr. LAFALCE. That is a grievous situation, it seems to me. It is probably applicable in virtually every case where product liability insurance exists because it is seldom that you only would have one product. Also, it would seem to me that this would be greatly exacerbated when you then impose excess limits coverage above and beyond.

Mr. NEIDICH. That is correct.

Mr. LAFALCE. The multiple product inequity.

Mr. NEIDICH. That is correct.

Mr. LAFALCE. Isn't there any way of quantifying the extent of the multiple product equity compounded by the excess limits hypothetical?

Mr. NEIDICH. No. I am not aware of how to go about doing that or what or how that impacts the aggregate experience.

Mr. LAFALCE. We have gone 10 minutes beyond 12 but the two bells now are summoning me to the floor of the House of Representatives for a vote, and the two bells followed by the five bells means, as you know, that it is more than one vote, it means there are probably going to be about half a dozen votes or more. So we are going to bring today's hearings to a conclusion.

Before I make any comments, I wonder are there any points that you would like to make that my questions have not brought out. Are there any questions that I should have asked that I did not ask?

Mr. NEIDICH. I have nothing else.

Mr. SCHWARTZ. Nothing. A very thorough first look at this.

Mr. LAFALCE. Well, let me say that again, I think that we have simply an outstanding product here, one of the most impressive documents that I have ever seen from the Federal Government, and certainly when it comes to an understanding of the insurance ratemaking process this document becomes a classic document without which one cannot discuss ratemaking in the future. It becomes required reading for anyone who wants to discuss intelligently, that is objectively, the issue of product liability insurance in general.

Of course, I am pleased that so much of your report did quote insight from previous reports of this and predecessor committees in its hearings and its reports which also had excellent editors.

Mr. SCHWARTZ. Without reference to the topic of incest, I would say we were most fortunate to have Mr. Neidich's services and his dedication to compiling this report and writing it in a relatively short period of time as something that is unprecedented in my own experience.

Mr. LAFALCE. If the administration doesn't pursue his report, who knows, he may switch from the executive back to the legislative?

Mr. SCHWARTZ. Or worse.

Mr. LAFALCE. With that, we are adjourned.

[Whereupon, at 12:15 p.m., the subcommittee was adjourned, subject to the call of the Chair.]

○

best copy available